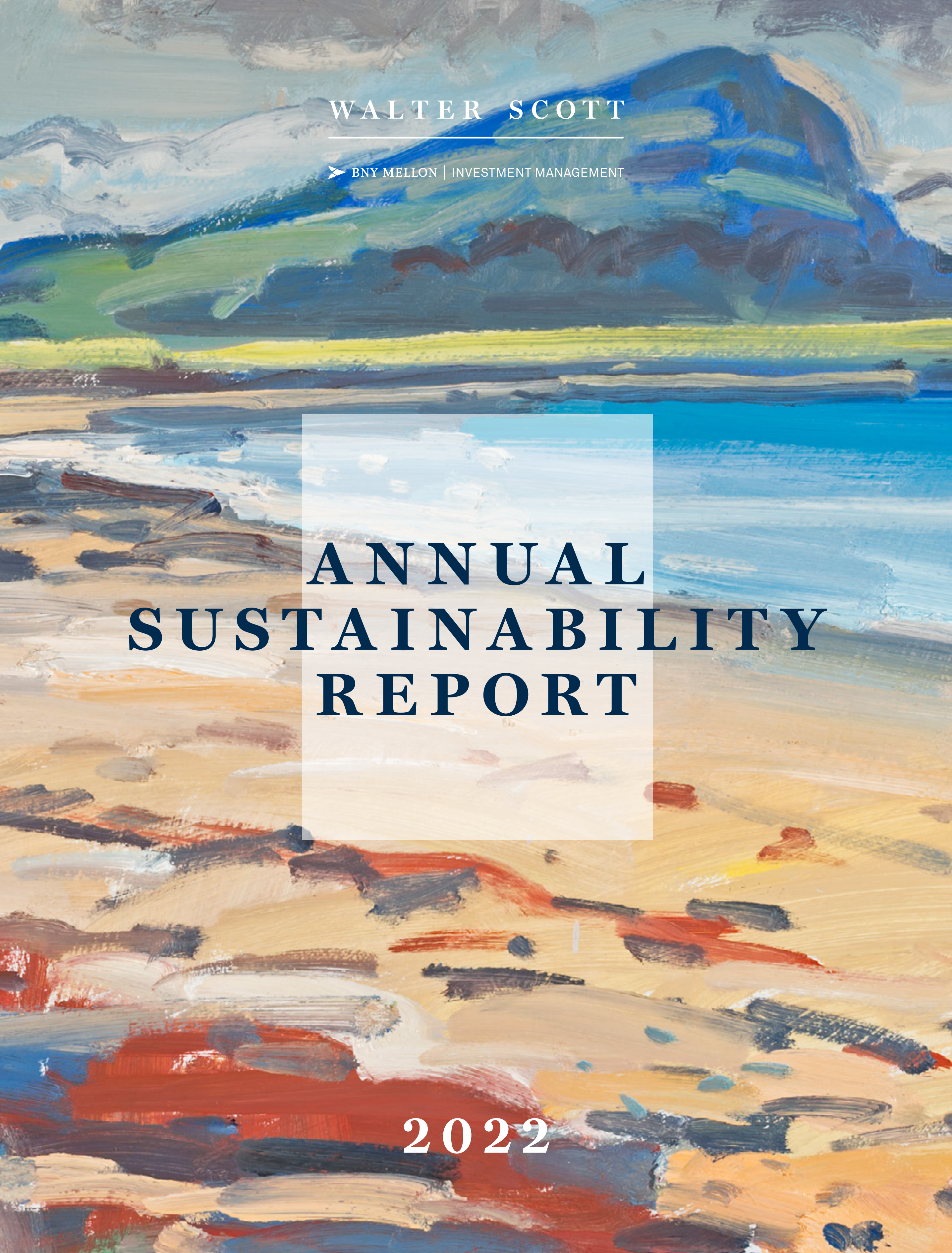


WALTER SCOTT

BNY MELLON | INVESTMENT MANAGEMENT

# ANNUAL SUSTAINABILITY REPORT

2022

# FOREWORD

**JANE HENDERSON**
Managing Director

When it comes to reviewing the developments of 2022, the French phrase "plus ça change, plus c'est la même chose" comes to mind. On the one hand, the world has changed dramatically around us. The return of warfare in Europe and the ensuing energy crisis have changed the political and economic landscape profoundly. Rising tensions in multiple spheres around the world and the return of double-digit inflation in most developed economies have also contributed to the sense that 'everything has changed'.

Compounding the feeling of a world in flux, the coronavirus pandemic has been in retreat but has not yet been defeated, continuing to have a significant impact on China in particular. We are still learning about the long-term implications of the pandemic on health, wellbeing and inequality. On top of this, you can add any number of climate-related natural disasters, such as the flooding in Pakistan, hurricanes in Florida or the prolonged droughts and heat events in many regions of the world, whilst temperature records around the world have been surpassed.

But for Walter Scott and the work that we do for our clients across the world, we also have a strong conviction that 'nothing has changed'. This doesn't refer to our portfolios, which despite our long-term outlook and low turnover, do evolve to take account of an ever-changing economic outlook. The business models of our investments also evolve, enabling them to weather both economic storms and structural changes in their marketplaces. It is our purpose and our core investment process that is constant – we are here to add long-term value for our clients by taking account of all relevant investment factors in a changing world, however they are labelled.

In the US, there has been renewed debate around the purpose of 'ESG', and whether the concept is consistent with fiduciary duty (spoiler alert: suitably defined and executed it is in our view an essential part of our fiduciary duties). We have plenty to say on this point in this report but suffice to say we believe that with respect to running a successful long-term business, delivering for your customers, fostering good stakeholder relations, and supporting and developing your

*“There has been renewed debate around the purpose of 'ESG', and whether the concept is consistent with fiduciary duty.”*

people is the most assured (and perhaps only) route to enduring profitability over generations.

For this reason, we believe that the ongoing debate about shareholder versus stakeholder capitalism is something of a distraction, and that there is no inherent conflict between managing a business responsibly on one hand, and shareholder return on the other. However, industry confusion still abounds on these points, and the relevant terminology is used in a range of different ways, sometimes creating contradictions and complexity. It is therefore understandable but nevertheless unfortunate that 'ESG' has become a politically contested construct at a time when all businesses are confronting a growing list of social and environmental risks and opportunities.

This, our third Walter Scott Sustainability Report, builds on years of developing disclosure in this area and covers a range of themes that are increasingly essential to long-term success. For us, 'sustainability' is about so much more than just environmental and social issues, important as they may be – it is about our investments and indeed our firm operating in a way today which enables future long-term financial success for our clients.

Furthermore, we were proud to be included in the first cohort of signatories to the UK Financial Reporting Council's revised Stewardship Code, and we are focused on continual improvement in this important and evolving area of our business. The Board of Walter Scott remains fully committed to the objectives and ethos of the UK Stewardship Code and the important work of the Financial Reporting Council in raising standards across our industry. This report also serves to outline Walter Scott's updated response to the UK Stewardship Code.

If you are interested in finding out more about our work across ESG integration and stewardship, then I commend this report to you.

Best regards,

Jane Henderson

Jane Henderson, Managing Director

*“We believe that the ongoing debate about shareholder versus stakeholder capitalism is something of a distraction.”*

# CONTENTS

# UK STEWARDSHIP CODE

## Overview of Reporting

As referenced in the foreword to this report, our Annual Sustainability Report incorporates our report on progress with respect to the UK Stewardship Code.

We have taken the approach of "integrated reporting" for two principal reasons:
- We believe that it is more helpful and accessible to our clients and stakeholders to have all relevant information in one place relating to our holistic approach to ESG integration and stewardship at a firm level and portfolio level.
- We further believe that sustainability, ESG integration and stewardship are inextricably connected in practice, and that external disclosure should ideally reflect this.

Having taken this approach, our objective has been to report on our progress across these connected areas in an intuitively understandable and engaging way, that reflects our culture and how we operate as a business. We are however equally committed to ensuring that our reporting meets and exceeds the requirements for reporting against the *12 principles* of the UK Stewardship Code. The table overleaf 'signposts' where relevant information can be found in this report with respect to the principles. Further information is also available on our website.

**ESG Integration and Stewardship Governance**

We expect a lot of the companies in which we invest on our clients' behalf. We must apply that same high bar to our own business, its practices and governance. Good and appropriate governance is critical in the effective stewardship of our clients' capital.

In our inaugural 2020 Stewardship Code Response, we outlined a number of enhancements that had been taken by Walter Scott's Board to further strengthen our governance framework. As part of that effort and aligned with greater articulation of responsibilities under the UK Senior Managers and Certification Regime rules, the Board committee structure was streamlined and enhanced. That board-level commitment to ongoing refinement in governance structures and processes remains unchanged and during 2021 responsibility for the firm's ESG Framework was added to the Statement of Responsibilities of the firm's Managing Director.

Further to establishing the ESG Project Steering Group and Sustainability at Walter Scott Group in 2020, several additional working groups were established in 2021 and 2022 to meet project deliverables. The Investment Stewardship Committee was also created in early 2021, replacing the previous Proxy Voting Group, with added responsibilities around stewardship and engagement. Aligned to that new structure, responsibilities were also allocated.

Hilda West is Head of Investment Operations and Sustainability and leads efforts across this dimension of our business, bringing teams together to improve our own practices and operations whilst also overseeing the investment and research related aspects of sustainability in its broadest sense. Hilda West also chairs the ESG Project Steering Group.

Whilst retaining stock champion responsibilities and being very much part of the Research team – in keeping with our integrated investment and research approach – Alan Edington is responsible for championing our research efforts across ESG integration and stewardship, supporting and directing the Research team. Alan Edington also chairs the Investment Stewardship Committee.

*"Our objective has been to report on our progress across these connected areas in an intuitively understandable and engaging way, that reflects our culture and how we operate as a business."*

**STEWARDSHIP CODE MATRIX**

| | UK Stewardship Code Principle | Covered in sections: |
|---|---|---|
| 1 | Signatories' purpose, investment beliefs, strategy, and culture enable stewardship that creates long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society. | - Foreword<br>- About Us<br>- Changing Terminology, Consistent Purpose<br>- Our Approach to ESG Integration<br>- People & Culture<br>- Giving Group |
| 2 | Signatories' governance, resources and incentives support stewardship. | - About Us<br>- UK Stewardship Code Overview of Reporting<br>- Changing Terminology, Consistent Purpose<br>- Our Approach to ESG Integration<br>- Additional Objectives Portfolios<br>- Appendix A |
| 3 | Signatories manage conflicts of interest to put the best interests of clients and beneficiaries first. | - Appendix A |
| 4 | Signatories identify and respond to market-wide and systemic risks to promote a well-functioning financial system. | - Engagement<br>- Climate Change<br>- Appendix A |
| 5 | Signatories review their policies, assure their processes and assess the effectiveness of their activities. | - Appendix A |
| 6 | Signatories take account of client and beneficiary needs and communicate the activities and outcomes of their stewardship and investment to them. | - About Us<br>- Changing Terminology, Consistent Purpose<br>- Our Approach to ESG Integration<br>- Proxy Voting<br>- Engagement<br>- Additional Objectives Portfolios<br>- Appendix A |
| 7 | Signatories systematically integrate stewardship and investment, including material environmental, social and governance issues, and climate change, to fulfil their responsibilities. | - Our Approach to ESG Integration<br>- Proxy Voting<br>- Engagement<br>- Additional Objectives Portfolios<br>- Appendix A |
| 8 | Signatories monitor and hold to account managers and/or service providers. | - Appendix A |
| 9 | Signatories engage with issuers to maintain or enhance the value of assets. | - Engagement<br>- Proxy Voting<br>- Appendix A |
| 10 | Signatories, where necessary, participate in collaborative engagement to influence issuers. | - Engagement<br>- Appendix A |
| 11 | Signatories, where necessary, escalate stewardship activities to influence issuers. | - Engagement<br>- Appendix A |
| 12 | Signatories actively exercise their rights and responsibilities. | - Proxy Voting<br>- Appendix A |

**Annual review**

The more formal structures and new roles around ESG integration and stewardship were implemented at the beginning of 2021. With more resource and greater definition of responsibilities, we were able to meet an increase in the number of requests from clients for information, analysis and commentary over the course of 2022. The structure also allowed us to more efficiently meet regulatory milestones. Looking over the year, working through new and emerging regulation was the most significant area of work across the various project and working groups.

Looking to 2023, we expect regulatory developments to continue to require significant resource. We are, however, confident that we are well-placed to address this work and adapt as interpretation of the new rules moves from analysis to implementation.

Another area of work in 2022 that will continue in 2023 is in relation to ESG data. Accessing robust and consistent data has been a material challenge for Walter Scott, as it has been for the wider investment management industry. In response to increasing client and regulatory demand for climate scenario analysis and climate metrics at portfolio and index level, and ESG data in general, we have subscribed to additional third-party data from a number of providers. These relationships also provide access to Principle Adverse Impact (PAI) and Sustainable Investment data, and other data metrics aligned with Sustainable Finance Disclosure Regulation (SFDR) requirements.

# ABOUT US

Walter Scott was founded in Edinburgh in 1983 as a global equity investment manager serving institutional clients. An early focus on the UK subsidiaries of US companies led to the development of a broad institutional client base in North America and then later around the world. Today, Walter Scott manages US$74.0 billion (as at 31st December 2022) in assets for institutional clients and distribution partners in all major regions.

The firm has maintained its investment philosophy and process, deliberately and consistently. A long-term investment outlook underpinned by rigorous research and highly selective investment are hallmarks of Walter Scott's approach. Team-based research and investment decision making are also critical characteristics with members of the Walter Scott Research team responsible for all aspects of company analysis, as well as engagement and proxy voting. Edinburgh has remained Walter Scott's home since 1983, and we added a client service presence in Boston in 2019.

With a well-defined and consistently pursued investment approach, the firm's stated objective has also remained unchanged. That objective is to achieve a real rate of return of 7-10% annualised over the long term. Our 'buy and hold' investment approach rests upon a long-term holding period, enabling companies to grow over industrial and market cycles and allowing the compounding of returns over time. So too, therefore, the returns we seek to deliver for clients are long-term in nature.

From the firm's early days, the founders were acutely aware that investment performance can only ever rely on best efforts, whilst recognising that in terms of client service and administration there could be no excuse for anything less than excellence. On that commitment the firm's business strategy was born, with a focus first and foremost on existing clients. Much of Walter Scott's success over time has come from that starting premise and those values continue to shape the firm's strategy today. Clients where tenure exceeds ten years account for 78% of the firm's assets under management, and additional funding from existing clients has been an important part of the firm's growth.

## CULTURE

Walter Scott's consistently applied investment philosophy and process, alongside its consistent client-first business strategy have been key pillars in the firm's success. Culture has also played an important role in that success, a culture set out by the firm's founders, and which endures today. That strong and distinctive culture has, of course, not endured through mere chance, rather it has been protected and maintained.

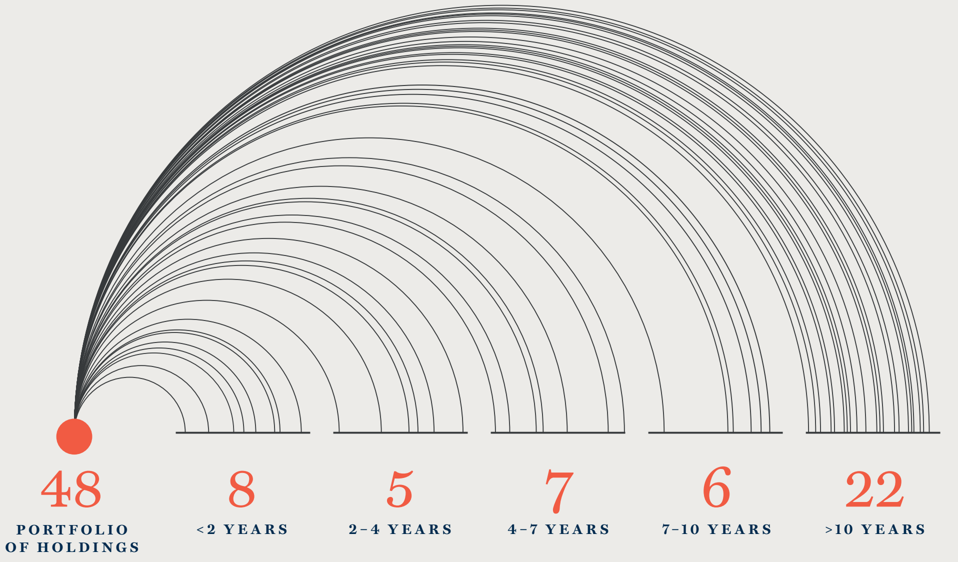
Long tenure of staff is another of Walter Scott's defining characteristics and one that has played an important part in a cohesive, collegiate, and meritocratic culture. Of the ten-strong Executive Management Committee, seven have worked at Walter Scott for longer than ten years, and five of those individuals for over 25 years. Similarly, of the 21 individuals that make up the core investment team, eleven have worked at Walter Scott for over a decade and three for more than 25 years.

That said, here again, the Board and senior management recognise the need to work hard to maintain that record of tenure, appreciating the need to protect Walter Scott's culture whilst also ensuring it is appropriate today in fostering a diverse, equitable and inclusive environment for new recruits as well as longstanding team members.

## OWNERSHIP

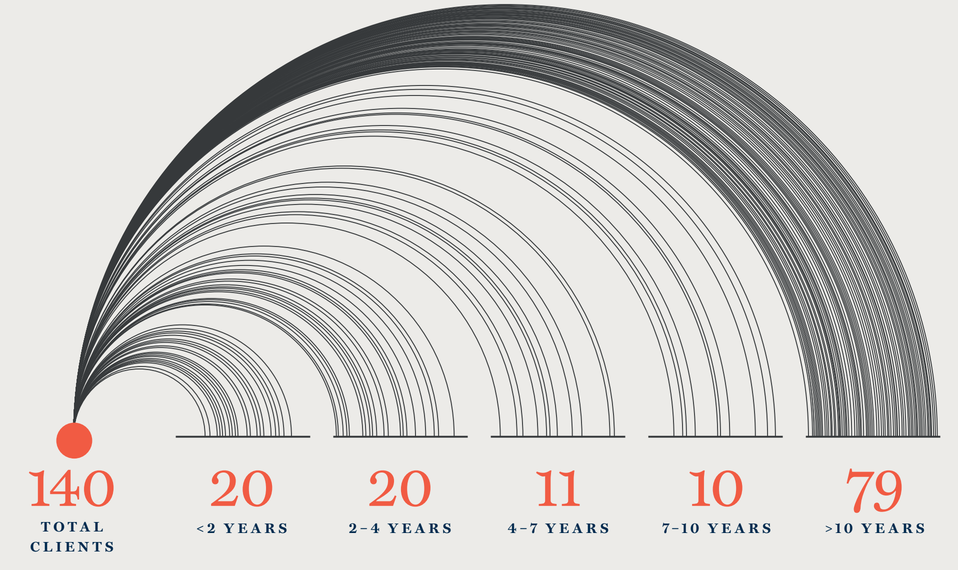
Walter Scott has been a 100%-owned subsidiary of BNY Mellon since 2007, one of a number of investment boutiques within its Investment Management division. The firm operates autonomously within that structure with BNY Mellon representation on the Walter Scott Board of Directors. The Board consists of an independent non-executive chair, four executive directors, including Walter Scott's managing director, and four other non-executive directors, three of whom are independent non-executive directors and the other being the CEO of BNY Mellon Investment Management who acts as a group non-executive director.

## BUY AND HOLD



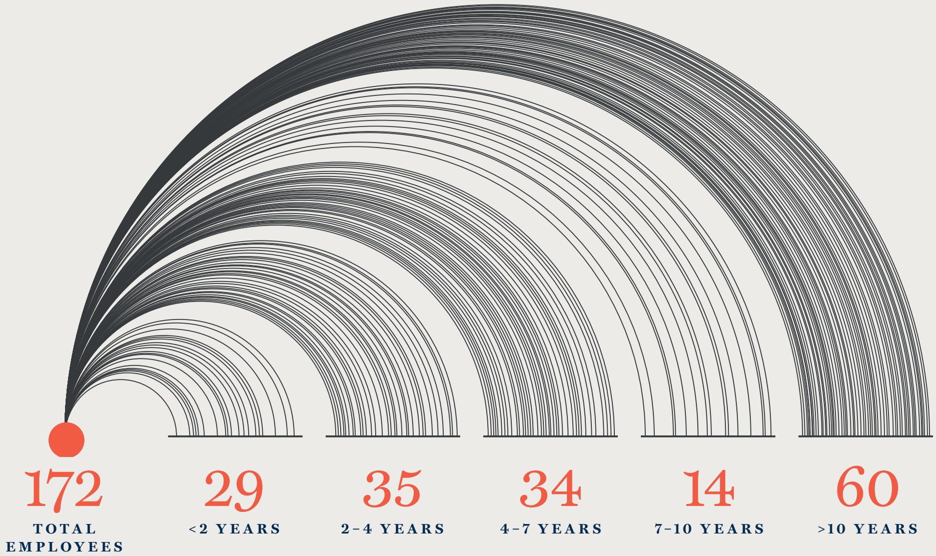

As at 31 December 2022. Source: Walter Scott. A representative USD-based global portfolio was used to illustrate this. Stocks sold and then re-purchased only include the duration held since most recent purchase.

## CLIENT LONGEVITY




As at 31 December 2022.

## EMPLOYEE TENURE




As at 31 December 2022.

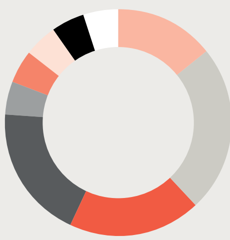
## INVESTMENT EXECUTIVE AND RESEARCH TEAM

**Team**
- Directors
- Co-heads of Research
- Investment Manager
- Investment Analyst

**Tenure (years)**
- 0-5
- 5-10
- 10-15
- 15-25
- 25+



**Gender**
- Male
- Female



**Faculty (undergraduate)**
- Science
- Economics
- Mathematics
- Law
- Management
- Engineering
- Philosophy
- Accounting
- History

As at 31 December 2022.

## WALTER SCOTT IN NUMBERS

### WALTER SCOTT

**1983**
Walter Scott & Partners Limited founded

**172**
Employees

**$74BN**
Assets Under Management

**140**
Clients in 19 countries

### INVESTMENT APPROACH

**1**
—TEAM—
One investment team manages all portfolios collectively

**1**
—PHILOSOPHY & PROCESS—
Consistently applied investment philosophy and process since 1983

**1**
—ASSET CLASS—
Sole focus on global equities

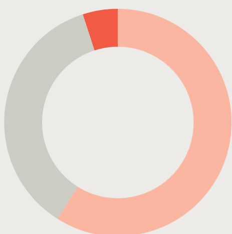
### CLIENTS

**9.8**
Average years length of client relationship

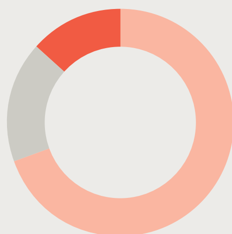
**78**
% of AUM managed for clients with tenure >10 years

**53**
% of AUM managed for clients with tenure >15 years

### ASSETS



**AUM by Product**
- Global – 59%
- EAFE – 36%
- Other – 5%



**AUM by Region**
- North America – 70%
- Asia Pacific – 17%
- EMEA & ROW – 13%

### OUR COMPANIES

**202**
Listed equities held across regions and sectors

**8.4**
Average years holding period

**39**
Longest holding period

**807**
Company meetings

Source: Walter Scott, all figures as at 31st December 2022.

# CHANGING TERMINOLOGY, CONSISTENT PURPOSE

> *“Despite the ever-shifting veneer of terminology, there is nothing new about ESG integration at Walter Scott.”*

**HILDA WEST**
**Head of Investment Operations and Sustainability**

There can be few areas of asset management, or indeed business in general, which have seen as much change or generated as much heated debate of late as ‘ESG’ and ‘responsible investment’. There are understandable explanatory factors for this, but before setting out our own evolving approach, a quick recap may be instructive.

## BACKGROUND

The earliest concepts of ethical investment were typically an extension of religious beliefs, with the first ‘restrictions’ adhered to by individual capitalists pertaining to areas such as money lending, the slave trade and alcohol. In more recent times this evolved into pioneering mutual funds with ethical restrictions, initially launched in response to the Vietnam War (for example, excluding companies involved in the production of military ordnance) but expanding over time to include a range of other issues as social and environmental consciousness grew amongst an increasingly educated and globally aware clientele. Ethical investment evolved into ‘socially responsible investment’, overlapping with emerging approaches to ‘green’ and ‘sustainable’ investing.

From an entirely different direction, growing shareholder activism as a response to corporate scandals in the 1980s and 1990s led to increasing interest in ‘corporate governance’ and ‘stewardship’, resulting in numerous government-backed reviews and codes of practice and the establishment of organisations such as the Council of Institutional Investors and the International Corporate Governance Network (ICGN). Over time, elements of these two distinct heritages came together in the somewhat unwieldy construct that we have all come to know by the acronym ‘ESG’ – environmental, social and governance. Following in the wake of the 2015 Paris Agreement on climate change and the launch of the UN Sustainable Development Goals, there has been an exponential increase in both activity and ‘noise’ relating to ESG and sustainable investment, latterly leading to regulatory intervention in the form of the EU’s Sustainable Finance Disclosure Regulation (SFDR) and the proposed UK Sustainability Disclosure Requirements.

## APPLES AND PEARS

For entirely justified reasons, asset owners and retail investors have at times been inspired, confused or dismayed by this ever-shifting semantic blizzard and inconsistent use of terminology and interpretation thereof. In the US in particular, there has been growing pushback from several quarters against a characterisation of ESG that some believe is more akin to a politically aligned ideology than a common-sense investment toolkit. At Walter Scott, we have observed this growing debate with both interest and consternation. The root cause of the problem is the issue alluded to above, namely the merging and subsequent conflation of two distinct concepts with different goals: the integration of financially material ESG considerations into investment research and asset allocation, with

> *“We define ESG integration in a straightforward way that is in our view entirely consistent with our fiduciary duties.”*

*"We have always been committed to 'integrating material ESG factors' into stock selection and ownership."*

a view to making better long-term investment decisions on one hand, and values-led ethical investment practices on the other.

Both are eminently laudable activities, but at Walter Scott we believe that there needs to be 'clear blue water' between the two approaches, which have markedly different objectives, as we have explained in the rest of this report. We define ESG integration in a straightforward way that is entirely consistent with our fiduciary duties – it is about understanding all financially material risks and opportunities pertaining to our clients' portfolios and factoring these insights into our investment decision-making process. It is therefore something that we do by default for all our clients, as we would consider our research incomplete without this information which could impair our ability to deliver our stated investment objective to clients. As well as providing an update on this ongoing work on ESG Integration and Stewardship in this report, we include a new section in the report focused on what we call our 'Additional Objectives Portfolios'. Whilst this nomenclature may be less inspiring than many of the more imaginative industry alternatives for sustainable investment funds, it is clear and consistent with our process. For those clients with additional 'sustainability focused' objectives, such as EU SFDR 'Article 8' type funds, we can offer variants of our core portfolios that in addition to our integrated ESG research have been subjected to rigorous additional stakeholder governance and sustainability analysis to determine the suitability of holdings. Pages 40-42 of the report provides more details.

For the avoidance of any doubt, these 'Additional Objectives Portfolios' are strictly 'opt in' and the additional methodology has been developed to meet the needs of those specific clients – we would never apply a 'values overlay' on the portfolios of clients who have not requested it or who do not support such an approach.

## THE INDUSTRY CALLS IT 'ESG INTEGRATION'... WE THINK OF IT AS COMMON SENSE INVESTING

Despite the ever-shifting veneer of terminology, there is nothing new about ESG integration at Walter Scott. Our business was founded 40 years ago with the firm conviction of being a long-term active owner of great companies on behalf of clients, and this core investment philosophy continues to serve us well to this day. From inception, our investment professionals have had the steadfast intention of identifying, understanding and taking account of the full range of financially material risks and opportunities confronting potential and current investments. Equally, there has always been a strong commitment to ongoing engagement with management teams, and thoughtful voting at company meetings.

In this sense, we have always been committed to 'integrating material ESG factors' into stock selection and ownership, long before the acronym came into the daily vernacular of the investment industry. We have innately considered corporate governance and business integrity factors in our analysis from the inception of the firm and have done so in a structured way as part of our 'Seven Sisters' research methodology for over 25 years. Trust in management is key, and over the decades we have not hesitated to sell an investment when we have had fundamental doubts about the integrity of its leaders. Looking back over the business school case studies, it is striking how the most notorious examples of rapid shareholder value destruction have typically been triggered by ethical and governance failings, Enron for example, or health, safety and environmental issues, such as in the case of Union Carbide.

We have always favoured a certain type of holding in our portfolios – focused companies with great cultures that without fanfare get on with delivering market-leading products and services that are valued by their customers and society alike. It is no surprise that we own more technology-led medical equipment manufacturers and specialist industrial services companies than investment banks in our portfolios. Good governance and thoughtful stakeholder relations go

*"Good governance and thoughtful stakeholder relations go hand in hand with durable companies that consistently create value over the long term."*

> *"ESG integration is in part about seeking to identify and understand the financial materiality of these emerging and often underappreciated risks and opportunities."*

hand in hand with durable companies that consistently create value over the long term.

In recent years, there has been a significant increase in expectations regarding how companies operate, as well as heightened focus on the social and environmental impact of their core products. Coupled with the communication power of the internet and social media, these expectations have resulted in businesses working in an increasingly complex commercial and regulatory environment, where reputation and integrity matter more than ever. The physical impacts of climate change are also creating new risks for all businesses. ESG integration is in part about seeking to identify and understand the financial materiality of these emerging and often underappreciated risks and opportunities.

This research is 'values neutral' and entirely in the best interests of clients – we need to understand the upcoming data privacy regulatory environment for technology companies, supply chain risks for fashion retailers, and the energy transition risks confronting natural resources companies and other more carbon-intensive industrial businesses in our portfolios. It is about anticipating how different markets and sectors will develop over the decades ahead, and how the long-term winners will be required to operate. It is for this reason that our work on ESG integration is led by our Research team, as stock champions are ultimately best placed to evaluate the overall financial materiality of ESG, supported by the scrutiny of the wider Research team. Even if the term didn't exist and we were never asked about ESG integration by clients (not the case) we would still be doing this work anyway as part of our investment 'due diligence' and our commitment to adding value for our clients.

There is more onus on us than ever before to keep evolving our approach to understanding ESG issues that will affect long-term investments and demonstrating how we rigorously factor these considerations into the selection, engagement and voting of our clients' holdings. We are therefore continuing to invest in our capability in this area and the coverage and utility of our relevant reporting and disclosures. The next section of this report has more details about how we integrate ESG in practice.

# OUR APPROACH TO ESG INTEGRATION

**ALAN EDINGTON**
**Investment Manager – ESG Integration**

As covered in the 'Changing Terminology, Consistent Purpose' section of this report, we define and approach ESG integration in a manner that is anchored around financial materiality. Our long-established 'Seven Sisters' integrated research framework remains unchanged. Stock champions have responsibility for all aspects of research into a company, as well as for engagement and proxy voting, and this responsibility extends to ESG considerations.

Why have we taken this approach? We don't believe that the important job of determining the financial materiality of ESG issues relating to our clients' holdings is something that could or should be outsourced to someone else, whether a separate team or a third-party research provider. As ESG integration is a 'wholly owned subsidiary' of good long-term investment analysis, then it is right that responsibility primarily rests with the stock champion. They have the best access to management and the most recent insights on applicable holdings. This way, when coupled with the wider scrutiny and challenge that comes from the whole Research team, we ensure that issues are considered holistically and in the context of our investment case for each company.

We analyse ESG issues through the lens of financial materiality (the importance and relevance of an issue to expected long-term performance). We look at these factors for all clients in all jurisdictions. Experience over 40 years has taught us that well-governed companies with valued products and good stakeholder relations have the best chance of long-term financial success, and this is becoming ever more important in a world increasingly focused on sustainability issues.

**What actually is 'ESG'?**
With so much industry hyperbole surrounding ESG, it is worth taking a moment to 'demystify' a topic which often gets debated in the abstract and typically comes wrapped up in layers of jargon and acronyms. ESG is a relatively new banner for a number of considerations that have long been innate to business decision making and investment.

**WHAT WE CONSIDER**

**We don't believe that ESG is a separate construct or a methodology that can be usefully applied in isolation from the financial analysis of our investments. For us, ESG issues are research inputs, not beliefs. ESG is shorthand for a number of issues that we think can potentially be important to the long-term financial success of our investments:**

**ENVIRONMENTAL CONSIDERATIONS**
Pollution and waste management; water; natural resource usage; biodiversity; circular economy

**CARBON RISK AND CLIMATE CHANGE**
Carbon risk and climate change; physical risk; transition risk

**HUMAN AND SOCIAL CAPITAL**
Bribery and corruption; conduct and culture; cyber security; data privacy; diversity; human capital management; labour rights; supply chain management; tax; community engagement and social license; product safety

**GOVERNANCE**
Board diversity, skills and experience; board independence; executive remuneration; shareholder protection and rights; succession planning; insider selling; related party transactions; uncancelled treasury stock; poison pills.

> *Our ESG research is about understanding, analysing and factoring in the full range of risks and opportunities that confront current and potential holdings.*

Whilst the majority of issues are not new, contemporary communications and regulatory disclosure requirements coupled with growing public interest is placing more attention on ESG factors in business than ever before. Our ESG research is about understanding, analysing and factoring in the full range of risks and opportunities that confront current and potential holdings. ESG integration is simply about ensuring that our research and analysis is comprehensive in a rapidly evolving global economy. As with all research and analysis in active investment management, 'looking forward' requires judgement, particularly with respect to considering the potential impact of emerging risks and opportunities.

As noted above, much of what is considered under the banner of ESG is actually just the latest iteration of long-standing social and economic considerations that are as old as capitalism itself. To give a topical example, there is (rightly) growing international debate about the best way to support a 'just transition' to a net-zero economy, taking account of the potential impact on consumer prices and the workforce and communities in regions dependent on fossil fuels, amongst other issues. Rather than being a new challenge, just-transition concerns have accompanied every major energy and technology transition in history. The machine-breaking Luddite movement grew out of the disaffection of 19th century English textile workers with the impact of mechanisation and automation on skilled workers in regions that specialised in textile production. Then, just as now in coal-mining communities in West Virginia for example, there were few alternative sources of employment in regions where one sector had come to dominate the local economy. In a very different context, many white-collar professionals are now facing the onslaught of artificial intelligence with the same feelings of trepidation as those experienced by the textile workers of middle England some 200 years ago.

When the 1833 UK Factory Act banned child labour under the age of nine, the debate preceding the passage of the legislation focused on both the financial implications as well as what we would now call 'ESG issues', with many industrialists at the time voicing concerns that the move would make UK exports less competitive in the global market. Whilst many mill owners had steadfastly focussed their efforts on lobbying to prevent such legislation, pioneering industrialists such as Robert Owen of New Lanark had already pressed ahead with removing young children from the factory floor years before, providing free onsite primary education instead and in time a ready supply of more educated and skilled employees for New Lanark mills, which went on to become one of the leading cotton producers in the world.

As recently as 1800, over 98% of global power came from livestock, biomass, hydro and wind. This was largely replaced by coal initially and then latterly by oil, gas and (in some markets) nuclear. We are now at the onset of a transition back to hydro, wind and biofuels, alongside solar and hydrogen. Transitions are disruptive and create new risks in the name of progress. The first commercial electric power station in the United States, built at Pearl Street in Manhattan in 1882, helped to replace the typically more dangerous and dirty gas lighting with electric illumination, but the facility burnt to the ground a decade later, torching the early investors in the Edison Illuminating Company at the same time. Had ESG ratings agencies been around at the time, a significant downgrade would no doubt have followed. In reality, new risks and opportunities accompany all significant innovations and economic shifts – financially material ESG considerations and trade-offs have accompanied every transition, and progress isn't always straightforward, linear or even immediately profitable. The most successful and enduring companies manage transitions astutely, taking measured risks and allocating capital to the transition at the optimal time. Fundamental, forward-looking company level research is required to weigh up the full spectrum of relevant financial risks and opportunities, and even then we won't always 'get it right' despite our best efforts.

The first corporate governance concerns and shareholder activism unfolded swiftly after the world's first initial public offering, when the Dutch East Indies Company floated in Amsterdam in 1602. Minority investors quickly complained about conflicts of interest and insider trading amongst the directors, and a proxy battle subsequently ensued in 1622, with retail shareholders agitating for the right to have more say in director elections. Similarly in the 19th and early 20th century, 'runs' on banks were commonplace occurrences following perennial revelations of corporate governance concerns and conflicts of interest amongst directors. More recently, from the 1950s onwards, there has been a resurgence of interest in corporate governance and shareholder activism following high-profile cases of minority holders losing out to underhand

**KEY ESG INTEGRATION ISSUES RESEARCHED AND DISCUSSED IN 2022**

| Sector / Region | Key issues and relevant holdings |
|---|---|
| Automobiles | – Growth of ULEZs and regulation banning sales of ICEs in near future [Ferrari]<br>– Electric vehicle supply chain issues (such as artisanal cobalt mining in DRC) [Ferrari] |
| Healthcare | – Access to medicine and vaccines [J&J]<br>– Patient safety in clinical trails [Dassault Systèmes]<br>– Healthcare worker shortages [Edwards Lifesciences, Intuitive Surgical] |
| Energy | – Transition risks arising from regulation [TotalEnergies, CLP] |
| Consumer goods | – Product safety litigation [J&J]<br>– Biodiversity impact [Jardine Matheson] |
| Fashion and Apparel | – Human rights risks in the supply chain [Nike] |
| Japan | – Board composition [Fanuc] |
| Technology | – Supply chain and resource management issues [TSMC] |

controlling shareholders or overly collegiate boards of directors and self-interested or hubristic management teams.

For clients who watch business news channels, some of the above may sound very familiar. Fast forward to the present, and our Research team has been busy analysing the range of different ESG themes that we consider in the investment case for all holdings. An overview table of notable areas of topical research is set out in the section above.

## INTEGRATION IN PRACTICE – 2022

After nearly two years of travel restrictions, the Research team was excited to return to face-to-face meetings in 2022. While virtual discussions proved an excellent substitute during Covid-19, getting out of the office to meet companies, industry experts and external stakeholders has always been integral to our investment approach. In the rapidly evolving area of ESG, it is arguably even more important to have a 'look under the bonnet' of glossy corporate reporting and the growing regulatory disclosures whenever we can.

Engagement is a key part of our ESG Research, augmenting corporate reporting and data. Coupled with our typically long holding periods, this enables us to build a detailed picture of how management teams approach various ESG risks and opportunities. ESG issues are playing an ever more prominent role in these conversations for one key reason – deft handling of a range of ESG challenges and opportunities is becoming increasingly financially material, and therefore on the agenda for management teams and board meetings alike. The Engagement section of this report provides further details on our engagements in 2022.

To support the Research team's work in this dynamic area and ensure that they have the necessary information to hand, we have also been investing in the capability of our Research Operations team. Building on the work that we have already done to develop a more streamlined and supported approach to proxy voting, we are developing our approach to accessing the best available third party ESG data on current and potential holdings, and integrating this information into our research process. To support this work, we added additional resources to our Research Operations team in 2022.

## KNOWLEDGE SHARING AND TRAINING

Knowledge sharing and continuous development is essential to the role of a Walter Scott Research team member.

> *"After nearly two years of travel restrictions, the Research team was excited to return to face-to-face meetings in 2022."*

## HYDROGEN – TAKING ANOTHER LOOK

**ASHLEY-JANE KYLE**
**Investment Manager**

**Having published the findings of our Carbon Project in early 2021, our research into the global energy transition continued last year. The value of this work is proving particularly apposite given 2022 may prove to be a pivotal year in the world's decarbonisation journey. Russia's invasion of Ukraine, rather than stalling the shift to renewables as some predicted, appears likely to hasten Europe's longer-term move towards cleaner sources of energy. In the US, the Inflation Reduction Act provides a route to decarbonisation for the world's largest economy. Both will bring risks and opportunities.**

One area of potential opportunity is hydrogen, which has been tipped to play an important role in the global transition to renewable energy. In the last couple of years, a surge in the number of new projects and a flood of capital into the industry suggests the pace of development in this area is increasing fast.

As a fuel, hydrogen offers several benefits. It can support the transition towards lower-carbon sources of energy from natural gas; it can be used as a store of renewable energy; and it can be generated using renewable energy by electrolysis. Another benefit, particularly pertinent at this time, is that hydrogen trade flows are unlikely to become weaponised or cartelised. Hydrogen can be produced from many energy sources across a wide variety of locations worldwide, so the trade in hydrogen is unlikely to lend itself as easily to geopolitical influence as has been the case with oil and gas.

> *“Hydrogen… can support the transition towards lower-carbon sources of energy from natural gas; it can be used as a store of renewable energy; and it can be generated using renewable energy by electrolysis.”*

At the moment, most hydrogen is produced from natural gas, so-called ‘grey' hydrogen or, if combined with the process of carbon capture and sequestration (storage of carbon dioxide so it is not released into the atmosphere), ‘blue' hydrogen. The most environmentally friendly type is ‘green' hydrogen, produced using sustainable energy from water molecules broken apart by the process of electrolysis into hydrogen and oxygen.

We are still in the early phases of the development of green hydrogen and the costs of production are still high. Research suggests the cost of producing hydrogen from renewables will need to fall significantly to make it a viable alternative to traditional energy. However, this could occur over the next decade – as we noted above substantial amounts of investment is flowing into the industry. The hydrogen industry is presently experiencing a significant growth spurt around the globe with more than 520 projects announced in 2021, up 100% from 2020. More than 15 countries across Europe, Asia and North America have integrated hydrogen into their national strategies with significant stimulus plans.

Hydrogen is therefore likely to become an increasingly important part of the global renewable energy mix. Industrial gas groups Linde and Air Liquide are supporting the growth of green and blue hydrogen, with both companies active in production, transport, storage and distribution. In 2022, we caught up with the management of both companies and our discussions covered their developing hydrogen businesses.

Linde has a long history in hydrogen technology. CEO Sanjiv Lamba stressed how Linde will be a clear beneficiary of the long-term trend of industrial decarbonisation driving demand for hydrogen. He pointed to examples such as demand for blue hydrogen from the US refining industry, often to obtain government incentives, and from the chemicals industry to generate blue methanol.

Linde has recently announced some significant hydrogen projects. One of them, a joint venture with ITM Power, will build and operate the world's largest proton exchange membrane electrolysis plant in Leuna, Germany. This facility should produce 4,500 standard cubic meters of hydrogen every hour.

Air Liquide is also a leader in hydrogen production. During a meeting with new CEO François Jackow, we discussed the company's energy transition strategy, including its production of green hydrogen. According to Mr. Jackow, the present crisis has served to accelerate Europe's energy transition, with customers and governments doubling down on decarbonisation. This is proving good news for the company, and its pipeline of decarbonisation opportunities has never been stronger. Europe is particularly supportive of green hydrogen, and earlier this year Air Liquide entered a joint venture with Siemens Energy to improve the cost-competitiveness of the technology by producing industrial-scale green hydrogen electrolysers. A new factory in Berlin is expected to be up and running in the second half of 2023.

Meanwhile, the Inflation Reduction Act has sparked a flurry of activity in the US. In the opinion of Mr. Jackow, the new legislation is great news for the world as there are now significant incentives for America to decarbonise, providing the country with a relatively low-cost route to becoming a low-carbon economy. It's also excellent news for Air Liquide. The biggest business impact will come from tax credits for carbon capture, utilisation and sequestration, which will incentivise the production of blue hydrogen. Several of the big Gulf Coast petrochemical players are looking to use blue hydrogen to produce blue ammonia, which uses a lower-carbon method of production than traditional ammonia.

Both Air Liquide and Linde are playing an important role in the development of hydrogen as a renewable energy source. They are both world-leading industrial gas companies at the forefront of the hydrogen revolution. Over the long term, they should both contribute to the creation of a more diverse and sustainable global energy market.

*“Both Air Liquide and Linde are playing an important role in the development of hydrogen as a renewable energy source. They are both world-leading industrial gas companies at the forefront of the hydrogen revolution.”*

The environment in our investment building on North Charlotte Street has been consciously crafted to foster the free flow of ideas, challenge and insights. Every member of the investment team (including Client Service) is also encouraged to deepen their knowledge by attending seminars, conferences, and events.

In 2022, a member of the Research team spent three days at a sustainability-focused apparel industry event in Copenhagen, whilst our Head of Client Service attended the US's largest corporate governance forum, the Council of Institutional Investors. A member of our Research Operations team attended the International Corporate Governance Network Global Proxy Voting Conference in November. In December 2022, two members of the Research team attended the Principles for Responsible Investment Conference in Barcelona (see inset box overleaf). More broadly, almost every company meeting now involves discussion of ESG issues to a greater or lesser degree. Two senior members of the Research team also completed the CFA's Certificate in Climate and Investing.

We are always keen to invite external speakers into our Edinburgh offices to present, share insights and challenge our understanding of relevant issues. Many of these talks had an ESG research focus in 2022. In November, Sir Ewan Brown presented on high-profile boardroom failures

**REPORTING BACK FROM THE PRI CONFERENCE**

**ALAN EDINGTON**
**Investment Manager – ESG Integration**

**CONNOR GRAHAM**
**Investment Analyst**

**In December, we attended the 2022 PRI Conference in Barcelona. As might be expected at a conference held by the world's biggest proponent of responsible investing, there were numerous informative and considered discussions about existing challenges and future regulatory and industry developments.**

Climate was, unsurprisingly, very much top of the conference agenda and there were interesting talks from the International Energy Agency on the energy transition – "the golden age of gas is coming to an end" – and former Bank of England Governor Mark Carney – "governments must price carbon and make transition mandatory". There was also a good deal of discussion around the progress and funding of the energy transition in emerging markets and the geopolitical dangers of dictating to developing nations, typically the hardest hit by changes in climate, without providing follow-on support. These insights will help inform our future analysis and debate.

Another topic of focus was human rights and how investors can best engage with investee companies on the issue. We can expect this to be a greater area of focus in the industry going forward, with implications for companies, asset owners and asset managers alike. Interestingly, the PRI is introducing its own human rights-focused platform for investor engagements, which will be the second largest collaborative initiative after Climate Action 100+.

There was also a great deal of discussion on the thorny topic of terminology and the risks it poses around greenwashing, mislabelling and misleading investors. This is an area in a great deal of flux (see 'Changing terminology, consistent purpose' earlier in this report) and the industry is still tentatively feeling its way towards a lexicon that participants can agree on. One risk is the potential for regulatory fragmentation across different jurisdictions. MSCI pointed out that of the ~1,400 funds labelled ESG or sustainable in the US, few meet the EU's thresholds under SFDR. Further evolution and regulation are inevitable.

> *"Climate was, unsurprisingly, very much top of the conference agenda."*

and shared his recommendations for improving governance and increasing scrutiny of the role of the Chair. Another speaker was Peter Tertzakian, author, economist and global energy analyst, who discussed the unfolding energy transition and how investors can better think about the investment risk/reward profile for fossil fuels relative to clean energy. Similarly, Rob West, founder of energy research consultancy Thunder Said, presented to the team in May about the implications of the global energy transition for the investment landscape.

It's also important that our wider company understands developments in our approach to ESG and changes in the broader sustainable investing landscape. In 2022, we held a knowledge transfer workshop for all Walter Scott employees on ESG integration and sustainability, and training was also rolled out across the entire business on a voluntary basis.

## THE YEAR AHEAD

The ESG landscape will continue to evolve in 2023, with more regulatory changes in the pipeline. Europe remains very much in the vanguard of the drive for greater

*“The ESG landscape will continue to evolve in 2023, with more regulatory changes in the pipeline.”*

regulatory oversight. On 1st January 2023, the SFDR Level 2 rules took effect, strengthening disclosure requirements to provide enhanced transparency to investors on the degree to which financial products consider environmental and / or social characteristics, invest in sustainable investments, or have sustainable objectives.

Here in the UK, the Financial Conduct Authority is consulting on Sustainability Disclosure Requirements and investment labels, with a view to “clamping down on greenwashing”. We have responded to the consultation and await its findings.

We can also expect to see the US Security and Exchange Commission’s new rule on climate disclosure come into force at some point in 2023/24. The rule, known as the Enhancement and Standardization of Climate-Related Disclosures for Investors, will require public companies to provide detailed reporting of their climate-related risks and emissions, and is aimed at helping investors make “informed judgments about the impact of climate-related risks on current and potential investments.” Keeping abreast of these and other changes and understanding the impact on our portfolio companies and clients’ assets will be vital.

Beyond the regulation, ESG issues can gain traction more quickly than ever before. In an increasingly globally connected world, civic society activism, social media and 24/7 news channels help to ensure that reputational risk travels in real time. In tandem with this, the pace of technological innovation is creating new risks and opportunities in areas such as biotechnology, energy transition and artificial intelligence. Companies are having to become ever more adept at navigating culturally nuanced sustainability challenges. To do this, they need to have the right management information and reporting systems in place, as well as the appropriate policies and management capability. It is for these reasons, for example, rather than just compliance with the relevant corporate governance codes, that we are interested as investors in having directors with a broad range of experience and insights on the board of multinational firms.

For all the above reasons, we will continue to invest in the ESG capability of our Research and Research Operations teams in 2023 and beyond to ensure that we are best placed to compound wealth for our clients over the long term.

# ENGAGEMENT

At Walter Scott, stewardship is the careful allocation, management and oversight of capital to create long-term value for our clients and beneficiaries. Good stewardship involves thorough background research, structured, purposeful dialogue or engagement with companies and considered voting of shares.

We are members of the International Corporate Governance Network, which works to promote effective standards of corporate governance and investor stewardship. We endorse its stewardship principles and align with its governance principles.

Responsibility for engagement and proxy voting sits with our Research team and Investment Executive, overseen by our Investment Stewardship Committee and supported by Research Operations.

Dialogue with companies has always been an important and valued part of our investment process. Through engagement, we signal our intentions and expectations as a long-term shareholder, building enduring relationships and achieving a more complete understanding of a company's strategy and practices.

## ENGAGEMENT IN 2022

We welcomed the return of face-to-face meetings in 2022 following the lifting of pandemic-related travel restrictions in many parts of the world. Some examples of those meetings and the subjects discussed are included in the pages that follow. The examples are split between Engagement for Information and Engagement for Change. While the latter will always be less numerous given the rigour of our pre-investment research into a company and our concentrated number of holdings, over the course of 2022 stock champions continued to identify issues where we believed we could leverage our position as long-term investors to actively encourage changes that are supportive of long-term value creation.

Our approach is pragmatic and constructive. Working with the Investment Stewardship Committee, stock champions must judge the likelihood that dialogue will drive change before a formal engagement for change is instigated. This helps us to prioritise and focus our efforts where they have the greatest chance of success.

## ENGAGEMENT FOR INFORMATION

**SGS**
On a call with the CEO of Switzerland-based testing company SGS, we sought further detail on the announced integration of sustainability criteria into capex decision making and senior management remuneration. Going forward, a sustainability assessment will now be part of all capex decisions in order to ensure that the business is well positioned for the future operating environment. In addition, a centralised pot of capital has been established for improving the energy efficiency of the company's buildings and car fleet. Regarding remuneration, senior management's long-term incentive plan will now include sustainability-related performance targets, with each individual having three key performance indicators (KPIs) that relate to their role in the business. For managers on the executive committee, annual bonus metrics will include sustainability criteria as part of the qualitative 'leadership assessment'.

The company is also tapping into the growing sustainable debt market having agreed a €1 billion sustainability-linked revolving credit facility (RCF) late last year. Under the terms of the RCF, SGS will receive a two basis-point discount on interest costs subject to meeting three sustainability KPIs. In combination these measures further strengthen SGS's sustainability credentials whilst improving funding costs.

**Booking Holdings**
The European Union's Digital Markets Act (DMA), agreed in principle in

*“Dialogue with companies has always been an important and valued part of our investment process.”*

## DEFINING ENGAGEMENT

**We distinguish between two types of engagement:**

**Engagement for Information** – a meeting or correspondence involving a two-way exchange of information.

**Engagement for Change** – typically a series of one-to-one meetings and correspondence, where we seek influence with a defined objective. An engagement for change will often relate to sustainability issues and our tailored approach enables us to focus on the issues or concerns material to each company. Through constructive dialogue, we encourage management to take the steps necessary to address areas of concern. Engagements for change are very often long-term in nature, involving numerous meetings with management and close monitoring of progress. Our experience of engaging with companies suggests there is no perfect sustainability scorecard and all companies face different issues of varying materiality. Given the rigour of our analysis before making an initial investment, we find the need for engagements for change relatively limited when compared to engagements for information.

The decision to pursue a specific engagement objective can come from a number of sources:

- The stock champion responsible for a company identifies an objective and seeks confirmation to proceed from the Investment Stewardship Committee.
- Another member of the Research Team or Investment Executive identifies an objective and flags this to the stock champion responsible for the company. Agreement to proceed is then sought from the Investment Stewardship Committee.
- The Investment Stewardship Committee identifies engagement objectives for specific companies or a thematic engagement across multiple companies.

The criteria for engagement for change considered by the stock champion and the Investment Stewardship Committee include:

**Does the company:**

- have financially material risks and/or opportunities where change, in our view, would benefit shareholders,
- that are addressable,
- where dialogue would contribute to change.

Where the answer to each of these is affirmative then the Investment Stewardship Committee has discretion to conclude that we should engage for change. The Committee and stock champion will agree objectives and milestones, which will be communicated to the company in question. Progress on an engagement for change is tracked and recorded through a number of potential stages:

- **Stage 1** – Raise the issue with the company (typically in writing)
- **Stage 2** – Company responds acknowledging that there is an issue
- **Stage 3** – Company demonstrates a plan to address issue
- **Stage 4** – Issue has been addressed, with evidence
- **Stage 5** – Issue has not been addressed – after consideration, the company reject our change objective
- **Stage 6** – The objective is no longer relevant (we have either sold the stock or the situation has evolved).

Should an engagement for change reach stage 5 or if the company has not acknowledged the issue, the Investment Stewardship Committee will consider escalating the issue. Issues are considered on a case-by-case basis, but possible escalation strategies can include:

- Communication with more senior management or board member.
- A formal letter.
- Engagement with the chairperson of the relevant board committee.
- Voting against or abstaining on management proposals.
- Collaboration with other investors.

Typically, our preference is to use our influence as long-term owners to engage with companies on areas of concern rather than divest. However, should our escalation strategy prove unsuccessful, we may choose to sell our investment.

> *While management now believes Alimentation Couche-Tard has established a winning formula for the EV customer, there is still plenty of innovation underway to further improve the EV experience.*

March 2022, hands the European Commission new powers to enforce competition rules on those large digital companies deemed 'gatekeepers'. Under the new regulations, companies like Apple and Meta will have to prove they are not hampering competition or they could potentially face fines of up to 20% of their global turnover. Not long after the DMA was announced, we met with online travel agent Booking Holdings to discuss the potential impact. With the agreement still in its infancy, the main question for Booking is whether it will be categorised as a gatekeeper. Based on the agreement's quantitative criteria, it appears likely that this will be the case, although management believes some of the criteria are not necessarily appropriate for Booking. Given the need for further clarity, discussions with the regulator are ongoing and we will continue to engage with Booking as the situation develops.

**Samsung Electronics**

In a meeting with Samsung Electronics, we asked about recent press reports suggesting that cultural issues between management and engineering teams had led to delays in technology development. The reports were largely based on contributions to an anonymous publicly accessible employee message board, some of which appear to be factually incorrect. However, the company did admit that it is having to tailor elements of its leadership culture to meet the expectations of a younger generation of employees. Last year's CEO change was in part a reflection of this shift in focus, and there is now greater emphasis on communication, town hall meetings, and relationship building with employees, suppliers, and customers. In our analysis of Samsung Electronics, we identify relations between management and the company's large and globally diversified workforce as a key risk, so it is encouraging to see management adapting to evolving expectations.

**Alimentation Couche-Tard**

In July, we spoke with the CFO of Alimentation Couche-Tard (ACT) to discuss the convenience store operator's electric-vehicle (EV) strategy. As the only global fuel retailer with a presence in Norway, the world's most highly penetrated EV market, the company enjoys a unique insight into the consumption and charging habits of drivers and a useful testing ground in which to trial new concepts and ways of operating. These learnings will prove invaluable as ACT looks to roll out its EV strategy in other geographies. While the transition from fuel to EV globally will take time, ACT is right to be on the front foot. Those who don't 'futureproof the forecourt' are likely to be left behind in the long term.

Central to ACT's EV approach is the provision of a high-quality in-store experience. With charging times of 20-25 minutes, EV customers are not only more likely to enter the store from the forecourt than traditional fuel customers, but they also spend more when inside. This makes it vital that customers enjoy a safe and clean environment, with comfortable seating, a broad product assortment, appealing foodservice offering, and good-quality internet. Today, ACT's Circle K stores are the number one destination for on-the-go charging in Norway. Contrary to the company's initial expectations, the best performing Circle K stores are not those on highways serving customers making long journeys, but rather those in more urban locations, where apartment-living makes at-home charging impractical – a useful learning as EV penetration expands elsewhere in Circle K's estate.

While management now believes ACT has established a winning formula for the EV customer, there is still plenty of innovation underway to further improve the EV experience. Through the company's EV app, customers can now charge their vehicles at those times of the day when electricity is cheapest. Technology has been introduced that automatically invoices employers for the cost of charging company cars at home, while loyalty schemes have been established that bundle together fuel sales and EV charging for those customers that require both.

**Cognizant Technology Solutions**

In today's tight labour markets, talent retention is more important than ever. This is particularly true in the IT consultancy & services sector, where rates of employee attrition have been historically high. A call with the CEO of Cognizant Technology Solutions was an opportunity to discuss how the company aims to improve staff retention in both the US and India. While acknowledging that a stubbornly high employee attrition rate has been frustrating, the CEO was quick to emphasise that Cognizant is less of an industry outlier than some observers assume, referencing Infosys as a competitor with a similarly high rate of departures. The CEO was also able to point to an improvement in Cognizant's employee engagement and satisfaction scores, which have been getting better across all survey categories and sit above the industry benchmark.

Remuneration and career progression are also being addressed. Detailed analysis over the last few years revealed Cognizant's pay was relatively low by industry standards. Encouragingly, the gap has now closed significantly, particularly in India. It is much cheaper to pay a little more to retain an existing employee than it is to backfill a position with an expensive hire. It's also true, however, that simply throwing money at employees is often a short-term fix, with staff turnover typically returning to prior levels within 4-5 months. The lasting impact of promotions is significantly greater. Cognizant has focused on feeding the employee pyramid from the bottom up, then subsequently promoting from within. A highly visible path to career progression not only improves employee morale but is also much less expensive than growing headcount through external hiring. Cognizant is now offering promotion opportunities on an ongoing basis rather than annually. Since this model was introduced last June, 33,000 employees have been promoted, with a positive impact on retention.

**ENGAGEMENTS FOR CHANGE 2022**

**16**
Engagements for change

**12**
Open engagements for change

**4**
Closed engagements for change

**REVISITING OUR 2021 ENGAGEMENTS FOR CHANGE**

**Of the engagement for change examples highlighted in our 2021 report, one is still outstanding. For all our engagements for change, we ask if the company in question:**

- has financially material risks and/or opportunities where change, in our view, would benefit shareholders,
- that are addressable,
- where dialogue would contribute to change.

### COGNEX

**Background:** In 2021, having acted as the lead investor in CDP's annual engagement with Cognex, our own engagement provided an additional route to expressing our wish to see greater disclosure across key metrics with KPIs to allow progress to be tracked. Through that engagement we were reassured by the acknowledgment and awareness that the company's disclosure on sustainability issues was somewhat behind the times and that management was actively working to address this. However, Cognex did not respond to the 2021 CDP campaign, and we resolved to continue to engage and encourage improved disclosure.

**Update:** In June 2022, we were co-signatories to the 2022 CDP non-disclosure campaign letter sent to Cognex. This time, management responded and assured us that our request regarding CDP had not been overlooked and that the company was focusing its efforts on publishing an inaugural sustainability report which would include completion of a TCFD-aligned report. Duly published in September, the report marks an improvement in Cognex's disclosure and largely aligns the company with TCFD.

**Next Steps:** Because we want to ensure that our holdings could successfully operate and grow within a Paris-aligned global economy, we will continue to discuss emissions disclosure with Cognex and will consider the company's 2022 Sustainability Report.

## OUR 2022 ENGAGEMENTS FOR CHANGE

### CLP HOLDINGS

**Objectives:** Divest, repurpose, accelerate closure or put in place clear plans for all coal assets, both operated and minority interest. Continue to accelerate the decarbonisation pathway.

**Stage:** Acknowledged.

**Update:** In 2021, we successfully closed an engagement for change aimed at expediting CLP Holding's decarbonisation roadmap, with a particular focus on coal-fired assets. Despite this, we remained of the opinion that there was more that management could do to progress towards a business that is simpler, cleaner and less volatile. Consequently, decarbonisation continued as a major point of discussion with CLP during 2022.

A visit to our Edinburgh office by CEO Richard Lancaster was an opportunity to discuss the decarbonisation efforts of CLP's core Hong Kong electricity business. The chance to play a key role in the Hong Kong and wider Asia-Pacific energy transition has the potential to be a significant growth driver for CLP, so it was encouraging to hear from Mr. Lancaster that the business continues to make progress with both its short and long-term plans.

CLP has other coal assets outside Hong Kong, however, and in our view the company needs to put in place clear plans for their future, whether that involves divestment, repurposing, or accelerated closure.

The aim of this engagement for change aligns with CLP's strategy in terms of where the company expects to make the best returns going forward and where it wants to invest incremental capital. In recent discussions, management have indicated a willingness to take the issue forward and explore possible solutions.

**Next Steps/Conclusions:** Continue discussions on decarbonisation and progress on specific coal-fired assets. Continue to share our views and provide support for a Paris-aligned pathway.

### VAT GROUP

**Objective:** Disclosure of climate data in line with CDP.

**Stage:** Plan Issued.

**Update:** As a participant in the CDP non-disclosure campaign, we wrote to VAT Group, the Swiss supplier of high-end vacuum sealing technologies, requesting better disclosure of carbon emissions and, more broadly, improved climate change governance and strategy.

VAT Group has, by its own admission, been something of a laggard regarding sustainability disclosure and communication. This is starting to change, however, and while the company is still not yet where we would like it to be, some of the progress since we commenced our engagement has been very encouraging. The publication of an inaugural Sustainability Review in August 2022, for example, was a significant step in the right direction.

In December 2022, as further evidence of its desire to improve the standard of its sustainability disclosure, VAT Group commissioned an external party to conduct an ESG materiality analysis consultation with a range of stakeholders, including a small number of major shareholders. During the discussion on climate disclosures, we reiterated that the business should provide more information, including a CDP submission and TCFD-aligned disclosures. The results of the consultation will be delivered to the board of directors in the first quarter of 2023.

**Next Steps/Conclusions:** While 2022 was a year of positive developments in VAT Group's sustainability efforts, we expect the company to make further progress in 2023. Engaging when appropriate we will continue to monitor VAT Group's strategy, capability and commitment to reducing the carbon intensity of its business to a level consistent with a Paris-aligned global economy.

### ROCHE

**Objective:** Encourage Roche to sign up to CDP.

**Stage:** Unresolved.

**Update:** In 2021, we engaged with Roche, the Swiss pharmaceutical company, on its decision not to respond to CDP's disclosure request. Having failed to make progress on the issue, we met with representatives from the company in April 2022 to discuss its resistance to reporting to CDP. By way of background, Roche was an early adopter of CDP reporting, receiving a consistently high rating (A or A-) from 2011 up until 2018 when the company took the decision to cease reporting. That decision was taken because Roche believed CDP's reporting requirements had become excessive and that the additional information requested offered limited, if any, incremental value in the assessment of the company's already robust carbon risk and climate action credentials. At the same time, Roche also wanted to evolve its environmental strategy and take it beyond what it viewed as CDP's standardised approach. As such, the company has decided to align itself with the Science Based Targets initiative (SBTi), which it believes represents a more appropriate, targeted and outcome-oriented approach to carbon and climate risk.

**Next Steps/Conclusions:** Based on our conversation, it appears very unlikely that Roche will change its position on reporting to CDP, at least in the near-to-medium term. Roche's decision to stop reporting to CDP and instead align itself with the SBTi is unique among its peers but others may follow, especially if they also deem the latter to be a more appropriate approach towards addressing carbon and climate change risk. Given the limited scope for success and our understanding of Roche's commitment to evolving its environmental strategy, we closed the engagement for change.

### INTUITIVE SURGICAL

**Objective:** Encourage disclosure of scope 1 and scope 2 emissions.

**Stage:** Plan Issued.

**Update:** We have corresponded extensively with Intuitive Surgical on its sustainability credentials in recent years, including on how best it can improve its carbon strategy and disclosure. In October 2021, the company announced it was committed to aligning its external reporting with recognized disclosure standards, including those used by CDP, within the next 1-2 years and that more clarity around the proposed timeline would be made available after Q2 2022. In the interim, Intuitive would work to ensure that the relevant information was appropriately scoped, and that the disclosure methodology developed could be sustainably reported alongside other standards, such as those used by TCFD and SASB.

As signalled, we received further detail on the company's CDP plans during a call in August. TCFD alignment will begin with incremental disclosures in the company's 2022 sustainability report, which will be published in the first quarter of 2023. A response to the CDP questionnaire is expected to follow, probably by the end of 2023, although this will depend to some extent on the availability of information and CDP's reporting cycle. These efforts will be led by ex-CFO Marshall Mohr in his new role as head of business services. Intuitive has also hired a new head of corporate sustainability and social responsibility, Fahmida Bangert. In December, marking another step forward in its sustainability journey, Intuitive issued an ESG materiality survey, which the stock champion completed and returned. This is a positive step in seeking to understand what is important to shareholders.

**Next Steps/Conclusion:** Before deciding on next steps, we will wait for the release of Intuitive's Sustainability Report in early 2023 and assess the level of disclosure therein.[1]

### PIGEON

**Objectives:** Improved independence of the board and remuneration committee.

**Stage:** Initiated.

**Update:** In August, we initiated an engagement for change with Pigeon, the Japanese manufacturer of baby goods. The purpose of the engagement is to encourage Pigeon to move to a board structure that is majority independent and for both its nomination and remuneration committees to be fully independent, in line with international

[1]In February 2023, Intuitive issued its sustainability report, which included validated scope 1 and 2 GHG emissions and an inventory for scope 3 which is in the process of validation. This enabled us to successfully close our engagement for change.

best practice. In recent years, the company has taken positive steps on corporate governance by reducing board numbers, increasing independence, and voluntarily forming nomination and remuneration committees. At present, the board of directors is 50% independent, while each committee is majority independent and chaired by an independent director. However, in a formal letter to the company we shared our preference for an independent majority on the board and for both committees to be fully independent.

We followed up on our letter during a visit to Pigeon's Tokyo headquarters in September and a phone conversation with the company in early December. What is clear from both interactions is that Pigeon is moving in the right direction on the issues in question. The company aims to further reduce the size of the board over time and plans to do this by reducing the number of inside board members, which will in turn increase board independence. The intention is that the nomination and remuneration committees will follow suit, with full independence being achieved over time.

**Next Steps/Conclusions:** We are encouraged by these plans and by Pigeon's generally positive approach to reforming its governance practices. We will continue to monitor developments and engage when appropriate.

### PROCTER & GAMBLE (P&G)

**Objective:** Encourage P&G to accelerate its investments in alternative substances to palm oil and to expedite the shift to fully recyclable packaging.

**Stage:** Initiated.

**Update:** We initiated an engagement for change with P&G, the world's largest consumer goods company. The purpose of the engagement is to encourage P&G to accelerate its investments in alternative substances to palm oil and to expedite the shift to fully recyclable packaging. In December, we met with senior P&G representatives at the company's headquarters in Cincinnati, Ohio to begin discussions on these issues.

Palm oil is used in myriad everyday products, including detergents, hair care, and cleaning products. However, production of palm oil is linked to significant deforestation and biodiversity loss. As a significant user, P&G recognises that palm oil is a major issue but has found no scale alternative. Palm oil itself is already a natural substitute for a petroleum-based product. Rather than finding alternatives, P&G is focused on managing the supply chain where possible. All the palm oil the company uses is certified by the Roundtable on Sustainable Palm Oil and traceability is improving, although less so for palm kernel oil. P&G also enforces rigorous labour standards, carrying out field audits and using third parties to keep up to date with conditions in the supply chain. To supply P&G, palm oil plantations must adhere to these standards and the company will remove suppliers which are unwilling or unable to comply.

On packaging, P&G is committed to 100% recycled or re-usable packaging by 2030. In the near term, the biggest impact P&G can have is to reduce the amount of packaging it uses, and then to use as much recycled material as possible. While availability of recycled plastic can be an issue, the company, in collaboration with PureCycle Technologies, has developed a process that produces recycled polypropylene that is odour-free and clear in colour. This will have benefits for a range of manufacturers, and P&G has already licensed the process out to other companies. The next step for the company will be to ensure packaging is recyclable or reusable for the consumer. P&G has already made significant progress on its 2030 goal. At the end of 2022, 73% of packaging was recyclable or reusable, up from 55% in 2021. Based on current progress, P&G will likely meet its target well before 2030.

**Next Steps/Conclusions:** Having initiated the process and listened to P&G's views, we have established the next steps for this engagement. On palm oil, we will request more information from P&G on the traceability of its supply chain with a view to understanding what proportion of palm oil purchased is accounted for by tier-one suppliers and the palm oil mills. This should help us establish any gaps in P&G's supply chain management and monitoring framework and assess what, if any, further steps should be taken. Regarding packaging, we will continue to monitor the company's progress to encourage it to reach its target by 2030 or possibly before.

FASTENAL - CASE STUDY

## FASTENAL

**One prominent benefit of being a long-term investor is the opportunity to build a level of trust and understanding with management teams that supports genuinely open and constructive engagement over many years. This has proved particularly fruitful around issues of sustainability, where many companies in the early stages of incorporating ESG into their business strategies have sought our views on issues such as best practice and materiality.**

Walter Scott has been an investor in Fastenal since the early 1990s. Based in Winona, Minnesota, Fastenal distributes industrial supplies to manufacturing and construction firms in North America. Having started out in 1967 with a focus on fasteners, the company now has an array of different products for a huge range of applications.

In the best tradition of the American Midwest, Fastenal is a business founded on pride, humility, long tenure, and innovation. In our view, however, the company had scope for improvement on matters of sustainability disclosure. In many ways, Fastenal's modest culture risked concealing its excellent values and intentions.

Reflecting our concerns, we have been encouraging Fastenal to do more on sustainability-related initiatives and disclosures for several years, outlining to management our thinking on sustainability matters and explaining why we think good disclosure is important, not least as it makes the company more investable to a broader audience. And while initially hesitant, management has been markedly more receptive in recent years, proactively seeking our views on what the business could do better, what progress might look like and the potential impact of regulatory developments.

Reflecting the evolution of its approach to ESG, Fastenal now has dedicated sustainability resource in place and is developing a cohesive ESG strategy. Recent initiatives include reporting to CDP and conducting a first ESG materiality assessment, to which we were invited to contribute. The culmination of this work to date was the publication of the company's inaugural ESG report in January 2023.

> *"Reflecting the evolution of its approach to ESG, Fastenal now has dedicated sustainability resource in place and is developing a cohesive ESG strategy."*

> *"In the best tradition of the American Midwest, Fastenal is a business founded on pride, humility, long tenure, and innovation."*

One hugely positive surprise in the report was alignment with TCFD. Not so long ago, we were told by management that Fastenal was only approaching beginner – Accounting for Sustainability ranks companies as Beginner, Intermediate or Leader based on their level of disclosure of the TCFD recommendations – and that not only did the business not have a timeline to intermediate but that it didn't have a timeline to provide a timeline to intermediate. Today, it has produced a TCFD-aligned report alongside an ESG report.

Announcing the report's release, CEO Dan Florness spoke of Fastenal's growth goals having a "natural alignment" with the "ESG priorities of our stakeholders". The company's strategy going forward will be centred on "reducing resource consumption in our customers' supply chain". Pleasingly, this was something we had discussed previously with management and proposed as an area of focus. In our view, if Fastenal didn't exist, or weren't as efficient, then customers would have to hold considerably more inventory, with the associated impact on resource consumption and waste.

We wrote to Mr. Florness and Fastenal's CFO to compliment them on the content and tone of the report. In response, they thanked us for our input and support and highlighted that the report was a good example of what can be achieved when like-minded parties collaborate. It's a view that speaks to the benefits of long-term investing and considered engagement.

## ESG-FOCUSED ENGAGEMENT WITH FASTENAL

**2018**
September – Discuss scope 1 and 2 emissions and broader ESG credentials with Fastenal's CFO

**2019**
March – Proxy voting conversation covering a shareholder proposal on diversity reporting

**2020**
February – Discussed the company's increasing focus on a range of ESG matters

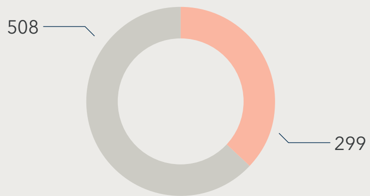
**2021**
June – Invited by Fastenal to outline our approach to ESG to the company's newly appointed sustainability manager

**2022**
December – Discussed Fastenal's evolving ESG strategy at the company's Minnesota headquarters

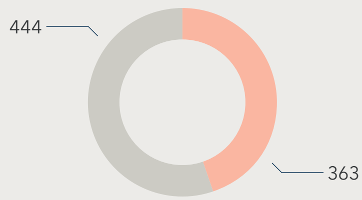
**2022**
December – Participated in Fastenal's first ESG materiality assessment

**2023**
January – Wrote to the company with compliments on the inaugural ESG report

## COMPANY MEETINGS[1]

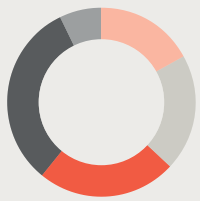



ESG discussed – 508
No ESG content – 299




Owned companies – 363
Non-owned companies – 444

## MEETINGS WITH ESG CONTENT SPLIT BY SUBJECT (2022)[2]



Carbon Risk and Climate Change – 17%
Environmental Considerations – 20%
Governance – 24%
Human and Social Capital – 32%
Other – 7%

[1] 1 January–31 December 2022.
[2] More than one subject might be raised in a single meeting.

## COLLABORATION

The consistent application of highly selective investment criteria, a long-term investment horizon and an approach that is agnostic to benchmarks, be that sector or geography, means that our scope to engage collaboratively is more limited than it might be for others. That said, we do recognise that there are instances where a collaborative effort is the most powerful way to try to effect change.

In 2022, environmental standards and reporting were again the focus of much of our collaborative efforts. Most notably, we participated in 29 collaborative engagements aimed at encouraging disclosure of climate data in line with the standards of CDP. Of these engagements, we were the lead signatory on two. In terms of measuring the outcome of this collaborative engagement, 12 of the 29 companies have since submitted a response to the 2022 CDP questionnaire and we will continue to engage with those who have not responded.

**Industry Initiatives**
We also continued to participate in industry initiatives to support the proper and effective functioning of financial markets. Given Walter Scott's size and sole focus on global equities, we remained selective in our involvement with industry groups and campaigns.

**FCA Discussion Paper (DP) 21/4: Sustainability Disclosure Requirements and Investment Labels**
We provided feedback to BNY Mellon, which in turn sent a coordinated response from all BNY Mellon investment boutiques.

**European Commission assessment of ESG ratings**
As part of BNY Mellon's response to the European Commission consultation, we shared our thoughts on a range of issues relating to ratings providers.

**UK government call for evidence on the UK's net-zero targets**
We provided a response to specific questions for investment management firms.

### MEMBERSHIPS

**We are members of or signatories to several groups that we believe best-represent client interests in pushing for meaningful change in matters of sustainability, including:**

**Principles for Responsible Investment**
*Signatory since 2017*
Membership reflects our commitment to responsible investment. We adhere to the PRI's six principles and report annually on our activities.

**CDP (Formerly Carbon Disclosure Project)**
*Member since 2017*
CDP is a not-for-profit charity that runs the global disclosure system used to establish company environmental impact and disclosure assessments.

**Climate Action 100+**
*Signatory since 2018*
Climate Action 100+ is an investor-led initiative to ensure the world's largest corporate greenhouse gas emitters take necessary action on climate change. Collaborative investor engagement involves interaction with over 100 of the most polluting companies in the world encouraging standard setting and improved disclosure.

**UK Investment Association**
*Longstanding member*
The IA is the trade body and industry voice for investment managers in the UK. Several Walter Scott representatives now participate in IA working groups. The aim of which is to agree/shape industry best practice and provide input into policy making and regulation.

**ICGN (International Corporate Governance Network)**
*Member since 2019*
Founded in 1995, the ICGN is a leading authority on global standards of corporate governance and investor stewardship.

We have also stated our commitment to the **UK Stewardship Code** and **Japan's Stewardship Code**.

## COLLABORATIVE ENGAGEMENT

**Our involvement in collaborative efforts around Raytheon's environmental reporting continued in 2022, with a focus on CA100+'s efforts to encourage companies to align their policies with its goals.**

Raytheon had originally scored poorly in CA100+ company benchmarking and following on from our discussions last year, we resolved to engage further with the company as it explored how best to improve its climate-related targets and commitments. There were encouraging signs of progress in May of 2022, when the business released its inaugural ESG report that showed positive steps on several indicators. Furthermore, attempts had been made to align ESG disclosures with the TCFD reporting framework. Our engagement has since been ongoing and we have met with the company to discuss how it might set long-term scope 1 & 2 GHG emissions reduction targets and disclose how its capital investment plans are aligned with its GHG emission reduction goals.

> *"There were encouraging signs of progress in May of 2022, when the business [Raytheon] released its inaugural ESG report that showed positive steps on several indicators."*

## SUPPLEMENTARY COMPANY ENGAGEMENT INFORMATION IN ACCORDANCE WITH THE UK STEWARDSHIP CODE

### ENGAGEMENT OUTCOMES

Our investment process leads to long-term holdings in some of the world's most successful companies. The issues that we decide to pursue in terms of engaging for change may be challenging. These are highly unlikely to be issues that can be quickly fixed. As such, we do not expect engagements for change to move quickly from initiation to successful close. We continue to refine and evolve our approach to engagement to ensure the best possible outcomes for our clients.

The examples of engagement for change shared within this report are intended to give an insight to the range of topics we discuss with management teams and the varied approaches.

### ESCALATION

We substantively reviewed and enhanced our approach to engagement for change in 2021, and have subsequently made further refinements. We now have a formal process to guide the agreement of objectives, agree the route most likely to achieve those aims and then provide approval to proceed. An important aspect of that process is periodic review and the related decision to change approach or further escalate the engagement. Whilst engagement for change is likely to remain less common relative to many of our peers, given our selective investment approach and focus on high quality, market-leading companies, over time this more formal and documented process is enabling us to report on success and common themes. There were no formal escalations in engagement over the year.

> *"The examples of engagement for change shared within this report are intended to give an insight to the range of topics we discuss with management teams and the varied approaches."*

**JUDGING PROGRESS**

With a more formal process now in place to discuss possible initiatives around engagement for change, there was certainly greater debate on this area than in previous years with Stock Champions putting their ideas forward and then working with the Investment Stewardship Committee to discuss feasibility and strategy before proposed plans are approved by the ISC and reported to the Investment Management Committee. As in 2021, many more ideas were put forward in 2022 than were approved to proceed and we would expect that pattern to continue reflecting a need to prioritise and pragmatically focus our efforts, whilst also considering timing and form of approach. We might decide collaborative engagement has a greater likelihood of success or if a company has begun to make improvements or has signified plans to do so, we might afford that company time to demonstrate that commitment before engaging for change.

> *"We might decide collaborative engagement has a greater likelihood of success or if a company has begun to make improvements or has signified plans to do so."*

# PROXY VOTING

As long-term investors, we have always considered proxy voting an important part of equity ownership. Considered proxy voting helps us ensure effective corporate governance and protect long-term shareholder value. It also allows us to express our views and initiate or contribute to change, to protect and promote the interests of our clients.

## OUR APPROACH

Reflecting that commitment, the member of the Research team responsible for an individual portfolio holding – the stock champion – is also responsible for proxy votes regarding that holding just as they are responsible for research and engagement. It has always been considered important that the person with day-to-day responsibility for monitoring a particular company and leading engagement with management, should also take the lead on determining voting decisions. Additional supplementary information relating to our approach to proxy voting is provided in Appendix A of this report and in our proxy voting policy available on our website.

We subscribe to the services of ISS as an effective means of receiving proxy voting documentation and then to action the vote informing applicable custodians. However, the voting decision rests solely with Walter Scott without any reliance on ISS recommendations.

We vote every proxy in a manner consistent with our clients' best interests. While we carefully consider management's views when determining how to vote, final decisions are always subject to our assessment of the likely client impact.

There is of course oversight and support. Given the rising complexity and breadth of items on AGM agendas today the extent of the support provided has increased in recent years. The firm's Proxy Voting Policy offers a robust starting point in ensuring consistent voting decisions. The Investment Stewardship Committee (ISC) adds a further layer of guidance and oversight.

The ISC is responsible for oversight and monitoring but also holds a formal advisory role. Where the Proxy Voting Policy is silent, a new issue has arisen or where there is any potential conflict, the ISC is empowered to deliberate and decide.

The Research Operations team also provides extensive day-to-day support to the stock champion. This includes managing deadlines, highlighting relevant issues and examples, providing annotated materials and reports, and where useful joining calls with company management or board members ahead of an AGM.

## POLICY

Walter Scott's Proxy Voting Policy, which is available publicly within the Sustainability section of the Walter Scott website, has evolved over the years and is prepared by us independently. We are confident that it is aligned with industry best practice and, more specifically, ICGN guidelines.

In 2021, we amended the policy to reflect our stance to generally vote against proposals requesting approval for ad hoc items. Prior to this, we had generally abstained, due primarily to a lack of information around such votes. This change led to a material decline in the number of abstentions in 2022 compared to previous years. The Proxy Voting Policy was last updated in April 2023, providing greater clarity with respect to our expectations on board composition, auditor rotation and disclosure regarding political donations.

Our ***Proxy Voting Policy*** applies across all investments, regardless of geography or strategy. It also applies across all clients for whom we are mandated to vote. Other clients make their own decisions on whether to vote, and how to vote.

We vote all proxies in line with our voting policy. If a client for whom we have voting authority instructed us to vote differently to our policy on a specific item then we would be able to facilitate this, however there were no examples of this in 2022. Clients in pooled funds or investors in funds managed by our distribution partners are not able to set their own voting polices.

## INVESTMENT STEWARDSHIP COMMITTEE

**Extract from Walter Scott's Proxy Voting Policy:** Voting is overseen by the Investment Stewardship Committee and all votes are signed off either by the Chair or Vice Chair of the Investment Stewardship Committee, Head of Investment Operations and Sustainability, Co-Head of Research, Head of Research Operations or in their absence a director of Walter Scott. The Investment Stewardship Committee will decide how to vote in the event a voting item does not fall within our policy or the investment manager or analyst has requested further guidance. Contentious issues also go to the committee for a final voting decision. The Investment Management Committee reviews any contentious voting decisions on a quarterly basis. The Research Operations Team is responsible for managing the proxy voting process. The team works with the investment managers and analysts to ensure voting is consistent and aligned with our current thinking and approach. The process is overseen by the Investment Stewardship Committee.

## ACTIVITY AND TRENDS

100% of votes were submitted where we had the authority to do so in 2022. Shareholder proposals continue to play a growing part in our discussions around proxy voting decisions, and in our engagement with companies. In the second quarter of 2022 alone, the ISC discussed more proposals than in the whole of 2021. And whilst many shareholder proposals have merit, still more demand a more nuanced approach. We evaluate each proposal individually and take due consideration of materiality and management's guidance. Certainly, if the proposal is in the long-term interests of stakeholders, we will vote in favour, but it is often the case that after further discussion with management as to what is in the best interests of stakeholders in the long-term, we will vote against shareholder proposals that might otherwise appear relatively uncontentious. Equally, we find these same management teams will typically embrace constructive recommendations from long-term investors, reflecting our view that ongoing engagement rather than shareholder activism is typically the most effective tool for achieving positive change.

Much of the increase in shareholder proposals in 2022 reflected the growing politicisation of environmental, social and governance issues. Remuneration was also one of the most contentious areas of proxy voting, with adjustments made during the Covid-19 pandemic continuing to reverberate.

We disclose on our website full voting records on a quarterly basis including a rationale for any votes against management recommendations. We remain of the view that the voting rationale can be as important as the vote cast and so we continue to review the best way to develop our public disclosure in an open, informative, and useful way. Our Shareholder Rights Directive II (SRD II) disclosures also provide detail regarding significant votes. The examples below are just a few of the many decisions made in 2022 with associated engagement and collective deliberation.

**Nike**

In advance of Nike's annual general meeting, members of the Research team met with senior representatives of the company to discuss shareholder proposals, including one relating to materials sourcing from China. Reports that the Uyghur ethnic minority group in China's autonomous Xinjiang region have been subject to forced labour in the cotton supply chain have led many to call on Western companies to source their materials from elsewhere. In this case, the shareholder proposal requested that "Nike adopt a policy to pause sourcing of cotton and other raw materials from China until the U.S. government Business Advisory is lifted or rescinded". Nike advised shareholders to vote against the proposal.

Supply chain and sourcing risk is an area into which we have conducted significant research in recent years, and it remains an ongoing focus for our Research team. In 2019, two members of the team undertook an extensive trip to Vietnam and Bangladesh to better understand sourcing risks specific to the Asian supply chain for the global apparel industry. It was clear from our conversations with industry participants and visits to manufacturing facilities that international brands were driving a consolidation around best-in-class suppliers but that risks remained, particularly regarding Tier 2 suppliers. As investors, we think this necessitates a pragmatic approach: we expect our investee companies to be fully committed to upholding high standards in their supply chains, while understanding that it is not realistic to expect them to eliminate risk completely.

> *“Shareholder proposals continue to play a growing part in our discussions around proxy voting decisions, and in our engagement with companies.”*

In our view, Nike is a market leader in this area, with an approach that continues to improve and evolve. While the company does not own or operate the factories which manufacture its products, it does implement a supplier code of conduct to which all facilities must adhere. This policy prohibits any type of forced labour, and regular evaluation, including announced and unannounced third-party monitoring, is conducted in a bid to identify non-compliance. Furthermore, by 2025, the company intends to source 100% of its materials from facilities that meet its sourcing criteria. At present, 85% of facilities in Nike's extended supply chain comply with these criteria, including 100% of Tier 1 (finished goods) suppliers. The company recently widened the scope of its 2025 target to include significant Tier 2 suppliers. There are also several initiatives in place aimed at improving traceability and mapping of raw material sources, including DNA testing. It is important to bear in mind, however, that this work is conducted on a 'best efforts' basis – it is extremely difficult for Nike or any other company for that matter to ensure 100% compliance within its supply chain.

Based on our conversation with the company and our understanding of its approach to supply chain issues, we took the decision to vote against the shareholder proposal. In our view, the proposal's fundamental objective – do no business with China – was unrealistic, given the country is integral to the company's Asia-focused sourcing model. And while it's true that there are risks involved in this model, Nike works hard to understand these and to support best practice and promote change where possible, setting the highest standards in the industry.

**Booking Holdings**
We discussed several proxy voting items on a pre-AGM call with Booking Holdings. For us, the key area of concern was the online travel company's remuneration report, particularly the structure of the executive compensation package, which we viewed as overly complex and poorly disclosed in places. We also had concerns about the extent to which the structure aligned with the interests of shareholders and the size of the proposed increase to the total compensation of the named executive officers. Whilst we believe that Booking's management team performed well through the pandemic, we did not view the significant increase in 2021's total compensation to be appropriate in the context of the total return experienced by shareholders in recent years. Ultimately, our conversation with Booking did not alleviate these concerns and we chose to vote against management's recommendation on its 'Say on Pay' proposal.

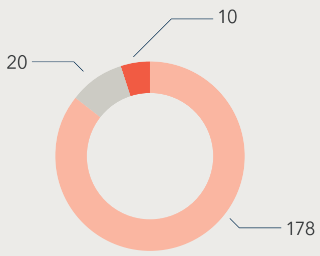
Having provided detailed feedback on the rationale for our decision to vote against the item, a call during the company's autumn shareholder programme was an opportunity to elaborate further on our concerns. After thanking us for our feedback, Booking's corporate secretary proceeded to outline some minor improvements to the 2022 remuneration plan. While more fundamental changes would have been welcome, it appears that the plan had already been broadly decided prior to the vote against the 2021 package. That said, we approved of some of the new measures and there are signs that the company is taking shareholder concerns to heart.

Overall, this was an encouraging call, and the suggested changes constitute a definite improvement. It appears that the 2023 proxy statement will reflect the company's post-Covid learnings, and we will wait to see if that proves to be the case. Rounding off the call, we reiterated our view that future disclosure must be clear and concise and that where possible the business should reduce the overall complexity of the plan.

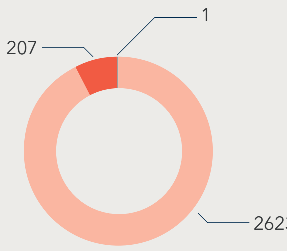
**Paychex**
We met with Paychex in advance of the payroll processor's AGM to discuss several governance related items, one of which was the upcoming 'Say on Pay' vote. Paychex has historically been inherently conservative in its remuneration practices. For many years, as measured both internally and by third parties, the company paid below the median level of its peer group, but consistently outperformed that peer group from a financial performance perspective.

However, its May fiscal year-end presented Paychex with problems when it came to setting compensation during the pandemic. When Covid-19 arrived in March 2020, the company was 46 months into a 48-month long-term incentive plan (LTIP), with performance running at 127% of target. Subsequent lockdowns lasted through the end of the LTIP period into July when the structure of the next plan was being discussed. It was in this context that the Paychex board sought to apply discretion with respect to the lapsing plan.

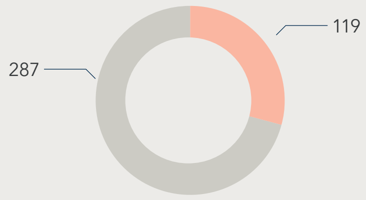
## PROXY VOTING OVERVIEW




- Total Voted AGMs
- Total Voted Special Meetings
- Total Mix Meetings




- Total proposals voted 'For'
- Total proposals voted 'Abstain' (0)
- Total proposals voted 'Against'
- Total proposals voted 'Withhold' (0)
- Total proposals voted 'One Year' (1)




- Total votes against Management recommendation
- Total votes against ISS recommendation

## VOTES AGAINST MANAGEMENT RECOMMENDATION RATIONALE

**65** Due to potential dilution >10%

**15** Ad Hoc Items

**7** Political donations

**1** Bundled resolutions

**9** Vague/poorly defined proposal

**4** Shareholder proposal

**3** Remuneration proposal

**5** Corporate governance issue

**1** Persistent failure to attend Board meetings

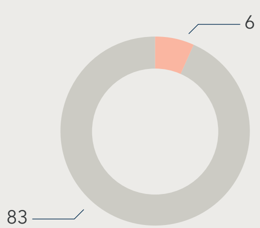
**1** Preference for a one vote per share structure

**6** Compensation and stock option plans

**1** Proposed dividend too low

**1** Adjournment – not in support of underlying proposal

## SHAREHOLDER PROPOSALS




- Shareholder proposals voted 'For'
- Shareholder proposals voted 'Against'
- Shareholder proposals voted 'Abstain' (0)

This voting summary for the full year 2022 reflects the votes cast by Walter Scott & Partners Limited during the period on behalf of our clients for whom we have full voting discretion.

## SUPPLEMENTARY PROXY VOTING INFORMATION IN ACCORDANCE WITH THE UK STEWARDSHIP CODE

### REMUNERATION

Executive compensation is often the highest profile and most contentious subject in proxy voting. The need to attract, retain and motivate management is important, but equally so aligning reward to long-term targets that are measurable, comparable, sufficiently demanding and that support a company's culture and ethos.

In 2022 we continued to see the added complexity of Covid-19 related adjustments. Previously set targets might have been put beyond reach, but many management teams have performed well in challenging circumstances and so altered plans have been put to a shareholder vote at a number of AGMs.

One of the aspirations behind the formation of the Investment Stewardship Committee in 2021 was that more time and focus would be directed towards looking at issues such as remuneration, to ensure both consistency in approach as well as ongoing debate and reflection on what is a dynamic as well as high profile topic. During 2022, we continued those discussions with debate around what we might collectively view as best practice, as well as what we would prefer not to see. Those discussions have centred on primary requirements such as transparency, robust yet straightforward explanation, pre-set performance targets and targets that are aligned with the long-term strategic objectives of the business. We would prefer not to see board discretion on executive compensation without sufficient rationale or good reason and lack of disclosure is increasingly unacceptable.

### VOTING PROCESS

We subscribe to ISS' services as an effective means to receive proxy voting documentation and then to action the vote informing applicable custodians. But the voting decision rests solely with Walter Scott without any reliance on ISS recommendations. Our Stock Champions all appreciate the need to undertake their own research, plan their own engagement and reach their own recommendations within the framework of the firm's Proxy Voting Policy, but do sometimes find it useful to test their thesis against the ISS view, occasionally to challenge or confirm thinking that is contrary to that of ISS.

Voting follows a two-step process. One person within the Client Operations team places the instruction on the ISS platform and another checks that instruction matches, as well as checking the voting information is entered correctly into our investment accounting system. If there is an instruction on a proxy vote that is client-specific then a manager in our Client Operations team also checks the instruction to make sure it has been submitted correctly. After submitting the proxy voting instruction, we do a 'ballot check' to ensure the accounts, and positions, that we have voted on through ISS match our investment account system information. This allows us to identify any issues straight away and to contact ISS or the custodian to promptly resolve any matter. We also receive a daily email from ISS that details any rejections, which also allows prompt resolution where need be.

The Client Operations team also carries out another layer of checks between our systems and the clients' custodians, to double check how many shares we expect to be voting on, incorporating whether the client has given us proxy voting authority. Votes are submitted through ISS and we check that our instructions have been successfully received by ISS. We also often inform the company of our voting decisions where there has been engagement on the issue or where there has been a vote against management and we want to re-iterate our case and concern.

100% of votes were submitted where we have the authority to do so in 2022. Instances where we do not have the authority to do so may be when the client has directed stock lending, POA is not in place, we do not receive the ballot from the custodian, or it is a restricted market. We continue to work as closely as possible with other providers, notably the custodians, to ensure that all proxies can be voted in a timely manner.

### VOTING OUTCOMES

Where any individual proposal receives less than 85% votes in favour, the stock champion is notified. Where votes fail, in addition to notifying the stock champion, the Research Operations team also notify the Investment Stewardship Committee so that those votes can be formally reviewed in the context of both our voting decision and possible engagement.

**STOCK LENDING**

We do not undertake stock lending. The arrangements for any client that undertakes stock lending will be agreed directly, and separately, by the client and their appointed custodian. We generally do not ask clients to recall stock on loan to vote unless we deem a vote to be particularly material.

*“We vote every proxy in a manner consistent with our clients’ best interests.”*

Throughout the whole process, we believe the board tried to stay true to its conservative pay philosophy, whilst also making sure that employees were rewarded appropriately to ensure effective staff retention. Despite some shareholder opposition to the use of discretion, we do not believe this was applied lightly. This was an extraordinary period, and it is hard to see a future scenario which would require the use of such discretion. The criteria that underpin the vesting of performance-based equity at Paychex relate to revenue and operating profit goals. This is very much aligned with how management thinks about the business - delivering strong top-line growth and maintaining already industry leading margins is key. The remuneration philosophy deliberately focuses on what Paychex is in control of, rather than using performance indicators based on peer-relative total shareholder return. For these reasons, we voted with management’s recommendation and for the ‘Say on Pay’ at the AGM.

**LVMH**

To vote in favour of a management proposal does not necessarily imply uncritical endorsement. Often, a decision is made “on balance” and only after careful consideration of myriad factors. In 2021, we wrote to LVMH expressing our view that, despite our support at the company’s recent AGM, better disclosure around executive remuneration would be welcome. LVMH is generally very transparent in its approach to reporting but there was, in our view, a lack of clarity around how the company structures compensation for its most senior representatives. To this end, we were encouraged by the improvements made to the 2022 package, notably the inclusion of environmental and social responsibility targets for bonus performance shares. While this positive direction of travel meant we were comfortable voting in line with management’s recommendation again at the 2022 AGM, we subsequently wrote to the company requesting a meeting to discuss gaps in disclosure that we believed could still be better addressed.

Following on from our letter, we enjoyed an open and constructive meeting with board member and former Chair of the Nominations & Compensation committee Charles de Croisset, who made it very clear that a desire for flexibility underpins LVMH’s approach to executive remuneration. In his opinion, luxury is a talent business, and some discretion is required to retain existing talent and hire the best new people. That’s not to say that remuneration is by any means arbitrary. A broad range of quantitative and qualitative criteria is considered when determining packages, but the company believes that the freedom to have a discussion on compensation is preferable to rigid and often complex metrics. The focus is very much on sustainable pay plans based on long-term growth and long-term results. Reflecting this, many senior executives at LVMH have significant shareholdings in the company, which align their interests well with those of external shareholders.

Our conversation with Mr. de Croisset was valuable in that it gave us a better understanding of how LVMH thinks about remuneration. While it seems unlikely that the company will disclose as much information in the near term as we would ideally like, it’s clear that LVMH thinks very carefully about how it remunerates senior executives and that it puts the long-term success of the business at the heart of compensation structures. This aligns with our policy preference for executive remuneration to “align the interests of management and directors with long-term sustainable value creation.” Taking these factors into account and given the company’s already excellent level of disclosure across many facets of the business, we remain comfortable for now with this approach.

*“Our Proxy Voting Policy applies across all investments, regardless of geography or strategy.”*

# ADDITIONAL OBJECTIVES PORTFOLIOS

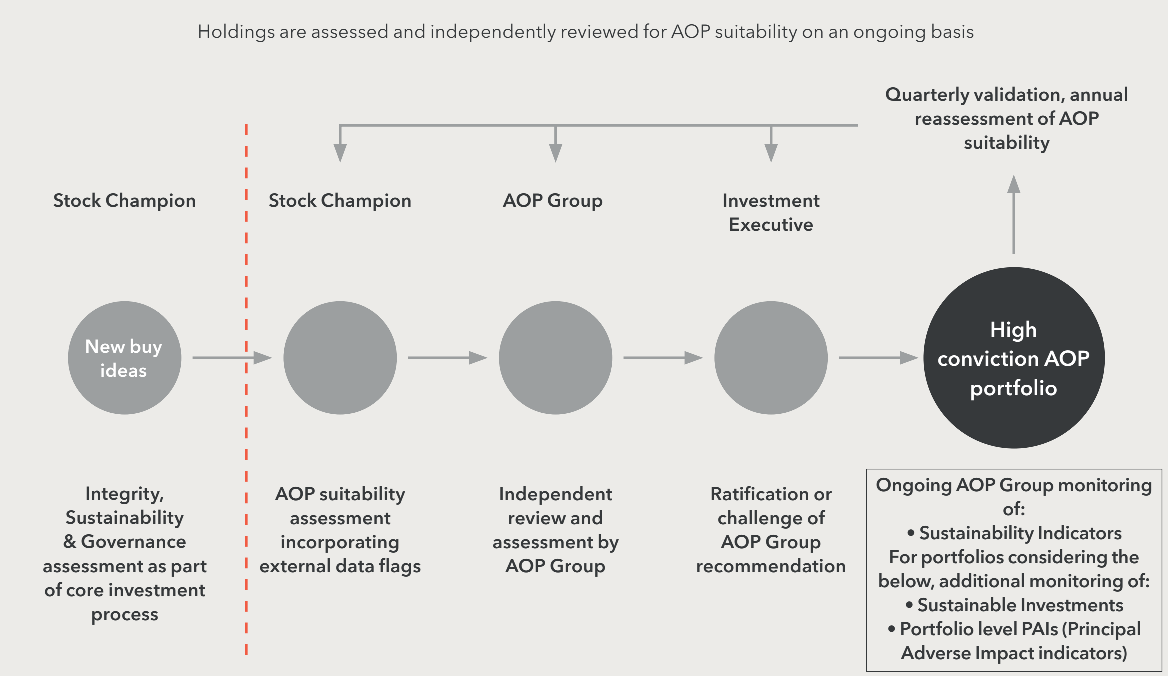
As we highlighted in the Changing Terminology, Consistent Purpose section of this report, we launched an additional process in 2022 for clients who want their portfolio to be managed in line with additional sustainability requirements, such as the 'Article 8' fund framework for "holistic analysis of environmental and social characteristics" set out in the EU's SFDR.

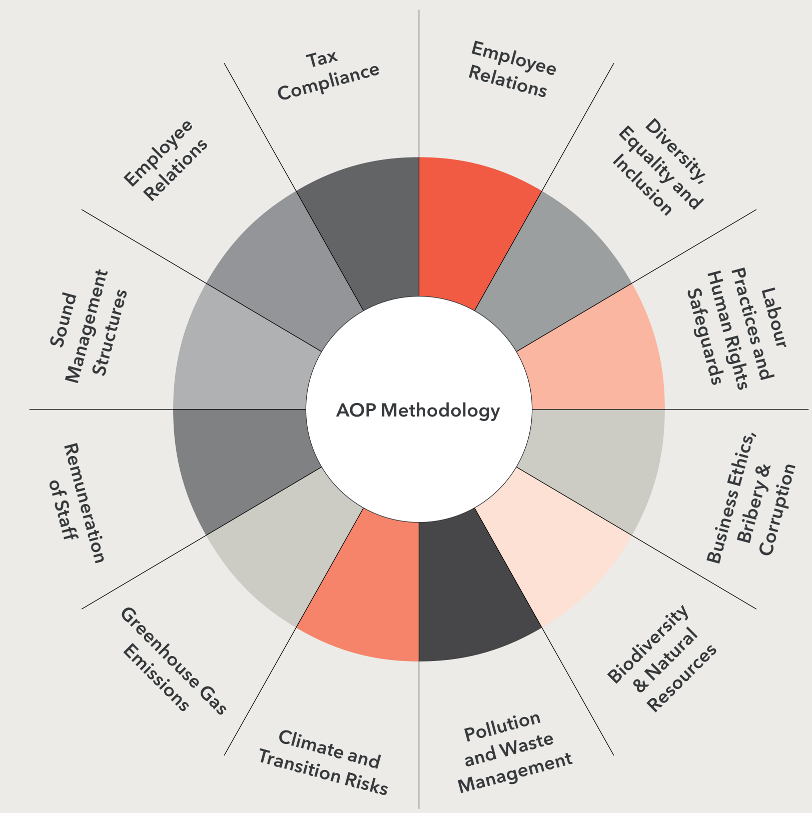
## OVERVIEW

The new 'Additional Objectives Portfolios' (AOP) methodology is the culmination of several years of work by a dedicated project team to understand the wave of new regulations coming initially from Europe and increasingly from other jurisdictions, and to develop a process for sustainable investment funds that builds on our longstanding work on ESG integration and stewardship. In addition to requiring a rigorous framework for assessing the suitability of existing holdings for these portfolios, we developed a separate governance framework to ensure that there was a review of all proposed holdings. The recently formed AOP Group performs this function, making recommendations to

> *"It is important to note that the AOP Group does not have a 'veto' over holdings in AOP funds or recommend new ideas."*

ADDITIONAL OBJECTIVE PORTFOLIOS ASSESSMENT PROCESS






our Investment Executive about the suitability of holdings. It is important to note that the AOP Group does not have a 'veto' over holdings in AOP funds or recommend new ideas, nor does it have responsibility for portfolio construction – decision-making responsibility continues to sit with the Investment Executive, supported by the Research team and the appropriate stock champion.

## AOP PROCESS

As we developed our approach, it was important to design a suitability assessment process which utilised the best available external data, but which was also fully aligned with our culture of rigorous fundamental analysis, anchored on the detailed company knowledge of our stock champions. We have been careful to ensure the conclusions from the 'Article 8' assessments required for all AOP holdings do not have any bearing on our willingness to hold companies in 'non-AOP' portfolios, although we do of course ensure that any financially material insights gained from the process that have broader relevance to all holders are shared with the Research team and relevant colleagues. The AOP Group is comprised of two members of the Research team and two members of our Research Operations team. The diagram on the previous page sets out the AOP process.

> *"The AOP descriptor is scalable across different regulatory regimes."*

The suitability assessment incorporates 12 ESG sub-themes (see diagram above) that we determine to be important in deciding whether a company meets the appropriate portfolio requirements (e.g. 'good

> *"There can be no electric vehicles or wind farms without effectively run mining and logistics companies."*

governance' and 'good or improving E&S characteristics'). This uses carefully selected external vendor data to augment the typically more qualitative fundamental analysis from stock champions of company performance on material ESG factors.

If a company 'flags' against the monitoring thresholds that we have set for each of the external data points, the appropriate stock champion will undertake additional analysis to determine the accuracy of the data and the materiality of the issues identified. Analysis is then reviewed by the AOP Group, including an overall suitability recommendation from the stock champion. As part of its review, if the AOP Group has any outstanding concerns it will arrange a meeting with the stock champion to discuss the matter in detail before a final recommendation is made to the Investment Executive with respect to suitability for respective portfolios. In addition to this core suitability assessment process, relevant data pertaining to additional SFDR considerations such as 'Sustainable Investment' classification (incorporating 'do no significant harm' checks) and portfolio level 'Principal Adverse Impact' indicators are also periodically reviewed by the AOP Group.

The AOP Group meets on a quarterly basis to review any material changes in the selected external data points (with appropriate stock champion analysis) which might have an impact on the suitability of AOP holdings. This includes a review of any holdings that have previously been deemed to be unsuitable for AOP clients to determine whether an issue has been satisfactorily addressed. The AOP Group also oversees the production of periodic reporting requirements for SFDR clients.

## WHY 'ADDITIONAL OBJECTIVES PORTFOLIOS'?

We chose this name for three principal reasons.

First and foremost, it is an accurate description of our actual process. Every holding for every portfolio goes through our rigorous proprietary investment research process to determine whether it has the ability to compound wealth for our clients over the long term. As a core part of this work, we assess and analyse relevant and material ESG factors pertaining to that company. This is consistent across all clients. It is only at this point that we assess our core portfolio holdings against any relevant 'additional objectives' mandated by our clients to determine suitability for their portfolios.

Second, the AOP descriptor is scalable across different regulatory regimes. Whilst the EU SFDR is the furthest ahead in terms of implementation, a number of other financial regulators, including the UK FCA and US SEC, are consulting on or developing additional disclosure frameworks for sustainable and responsible investing. We anticipate a degree of overlap across these different regulatory regimes and have developed an assessment methodology which we are confident is sufficiently scalable to enable us to meet or exceed the requirements of each market approach.

Finally, the name infers our belief that such portfolios are non-hierarchical with respect to our core funds, contrary to the inevitable consequence of naming a subset of funds as 'sustainable' or 'responsible.' As we always set out to find and own for all clients well-governed companies with great products and a clear long-term purpose, it is perhaps unsurprising that there is a very high degree of commonality across holdings within both core portfolios and AOP. Furthermore, our stewardship activities are unified across all portfolios – we don't believe that it is either practical, effective or appropriate to pursue different stewardship objectives for the same holding across our various clients and portfolios. We tailor our research and final selection criteria, but we engage with one voice.

It is important to us that we don't inadvertently suggest that any particular approach is 'better' – our role is to provide clients with information, clarity and choice, enabling them to meet their own broader investment objectives. For clients interested in sustainability, restrictions can play a role in effecting change and give investors clarity over what they can expect in their portfolios, but it is arguably just as important to have progressive, engaged long-term owners of the industrial and extractive companies at the core of our economic system today, challenging and supporting management to address the very significant transition challenges and opportunities. There can be no electric vehicles or wind farms without effectively run mining and logistics companies, and the challenge to transition to a lower risk net-zero economy falls across all sectors.

# CLIMATE CHANGE

We are due to publish our first entity level TCFD-aligned report in mid-2023. This section of our report provides an overview of our approach to climate change and a summary of key activity in 2022.

> *"A number of temperature records were broken in 2022, with the year proving to be the hottest on record in the UK and many other countries around the world."*

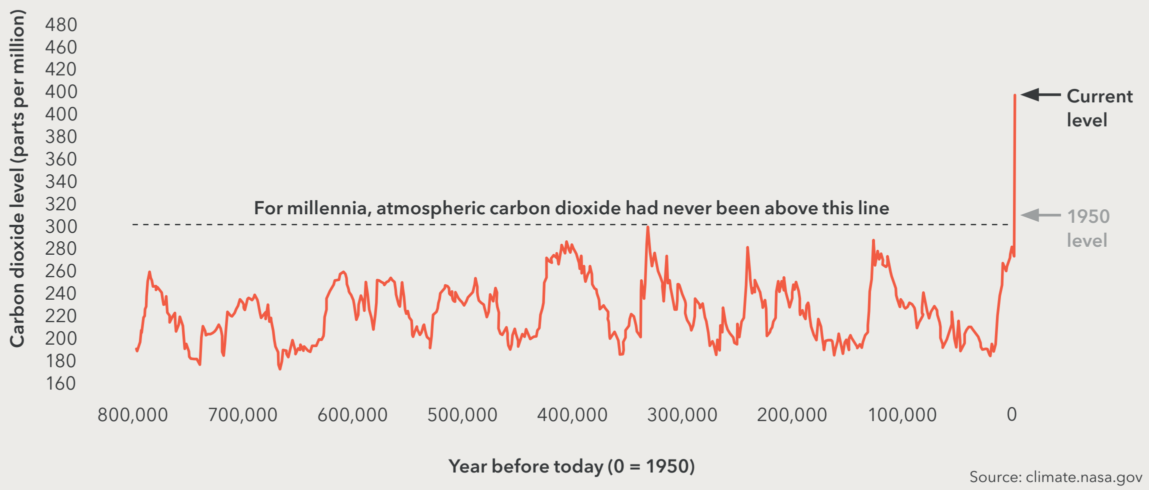
## BACKGROUND

The Intergovernmental Panel on Climate Change (IPCC) has concluded that the climate challenge confronting humanity is increasingly stark, and that the world is now close to crossing a threshold where it will not be possible to achieve the 'stretch' goal of the 2015 Paris Agreement, namely limiting global warming to 1.5°C this century. Despite well-intentioned emissions commitments from governments and private sector organisations alike, global emissions are rising again after a very brief pandemic induced hiatus. Consequently, atmospheric carbon dioxide levels continue to increase, as the chart below from NASA shows.

What are the implications of this? The IPCC guidance is that we can expect to see an increasing incidence of the extreme weather events that have been experienced in many regions of the world over the last few years. A number of temperature records were broken in 2022, with the year proving to be the hottest on record in the UK and many other countries around the world. The state capital of wildfire-prone California, for example, recorded an all-time high temperature of 46.7°C (116°F) in September.

In addition to heat events, there has been a marked increase in other weather-related challenges, which is why it is important for investors to understand the full range of risks arising from climate change in addition to rising temperatures. Large parts of Pakistan were submerged in water in early 2022, and insurance companies have declared recent floods in Auckland, New Zealand as the worst climate-related event in the country's

**GLOBAL EMISSIONS CONTINUE TO RISE**




Source: climate.nasa.gov

> *“Whether ultimately successful or not, transition efforts are already creating a range of different risks and opportunities for businesses.”*

history. Disruption to polar weather patterns is resulting in more volatile winters in many regions – generally milder temperatures but with the risk of more frequent extreme cold events.

The second implication of persistently rising emissions and real-world physical impacts is that we can now reasonably expect to see more concerted intervention from governments, international agencies and consumers in many parts of the world in the years ahead. Most OECD governments are signed up to the concept of ‘net zero’, with the fractious international negotiations now focused on how fast we need to go and who pays for a just transition.

## UNDERSTANDING TRANSITION RISK

Whether ultimately successful or not, transition efforts are already creating a range of different risks and opportunities for businesses. To give a very tangible example of such risks, take the automobile sector and the increasing number of countries that have set a date for the phaseout of the internal combustion engine. This regulatory intervention also creates as much opportunity as it does risk, giving the electric vehicle sector a collective ‘supercharge’. Understanding our holdings’ response to such transition risks and opportunities is a fundamental part of our ability to generate superior long-term investment performance.

There continues to be a spectrum of opinion on the science, causality and impact of climate change, and the importance (or otherwise) of taking concerted action to reduce emissions. However, transition risks arising from regulation and changing customer expectations are tangible, material and imminent. It is for this reason that we continue to believe that it is of material financial importance for all of our holdings to have the ability to successfully operate and grow within a Paris-aligned global economy.

The most significant transition risks clearly fall on the most carbon intensive companies in the economy. Climate Action 100+, the investor-led collaborative engagement network (of which we are a member) estimates that just 166 companies account for approximately 80 percent of corporate industrial greenhouse gas emissions globally. The purpose of the CA100+ initiative is to focus investor engagement efforts on these systemically important companies.

However, it is important to note that transition risks and opportunities are not just material to the largest emitters – every sector of the economy will be reshaped by the transition to a lower carbon economy. All companies are increasingly expected to understand their full ‘value chain’ carbon emissions and related environmental impacts, and to have a plan to significantly reduce these emissions within the next decade.

It is also important to note that not all physical and transition risks arising from climate change will be intuitively predictable, and certainly not without company specific nuance.
A virtual reality software company with principal offices in a high-risk weather event area may be more susceptible to climate risk than a traditional carbon-intensive manufacturing business in a more stable region. With respect to regulatory transition risks at a company level, a high carbon-intensity business providing an essential but ‘hard to abate’ service may be less exposed to transition risks than the manufacturer of a less carbon-intensive but ultimately more discretionary consumer product. Governments are highly unlikely to phase out essential services where there is no credible alternative.
Carbon emissions alone do not provide the full picture regarding the net ‘social utility’ of different kinds of businesses across the economy, and the corresponding transition risks relating to new regulations or shifting consumer sentiment.

Furthermore, there will be company specific ‘second tier’ transition risks that create commercial issues and opportunities for other potential holdings. To stay with the automotive sector example, a highly efficient, renewable energy powered company manufacturing specialist components for internal combustion engine vehicles may have relatively low carbon emissions but high transition risks. For these reasons, ‘bottom up’ fundamental analysis of investee companies is critical.

Therefore, our Research team undertake qualitative company level research on climate risks and opportunities as an integrated part of our investment research process, including:

- Ensuring that analysis of climate risk and opportunity is a core component of our Integrity, Sustainability and Governance research framework.
- Collection and monitoring of data on our holdings’ existing carbon disclosure and climate-related commitments (tracking alignment with net zero, Science Based Target initiatives etc), and reporting on this to the Investment Management Committee on a periodic basis.
- Engagement with relevant holdings to understand their position on climate

and encourage management to be proactive with respect to the transition risks outlined above, adding companies to our tracked 'engagements for change' list where required.

- We are also currently undertaking further portfolio and holding transition risk analysis to enhance our understanding of climate risks and opportunities.
- In addition to the above work on climate change, other material environmental considerations are included in our investment analysis.

While our research is proprietary, we augment our understanding of climate risks with information and analysis from external sources, including third-party research and data providers, academics, and subject-matter experts.

**Governance of climate risk**

The Board of Walter Scott has delegated responsibility for our climate change strategy to the Managing Director in her role as chair of the Executive Management Committee. The climate change strategy is subject to periodic review and challenge by the Board of Directors.

**Update on Portfolios**

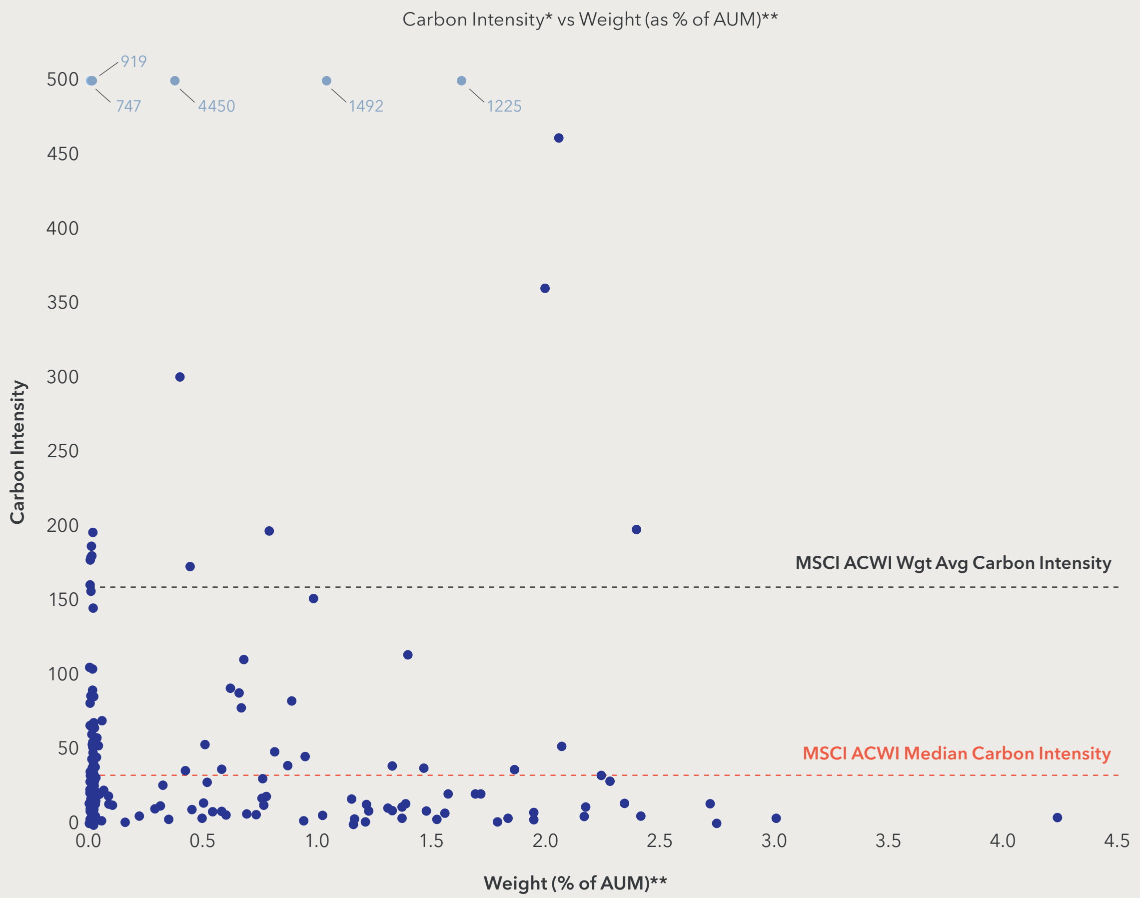
As noted above, a relatively small number of companies represent a large share of global corporate carbon emissions. The same is true of our portfolios. Details are provided in Table 1 on Walter Scott's top 20 holdings by weighted average carbon intensity.

**TABLE 1 – TOP 20 WALTER SCOTT HOLDINGS BY CARBON INTENSITY RELATIVE TO ALL HOLDINGS**

| Company Name | Relationship Start Date | CDP climate responder | TCFD aligned | Net Zero or SBT commitment | Carbon Intensity (Scope 1&2 $CO_2e$ / \$m Rev) |
|---|---|---|---|---|---|
| CLP Holdings | 1998 | Yes | Yes | Yes | 4450 |
| Air Liquide | 2012 | Yes | Yes | Yes | 1492 |
| Linde | 2010 | Yes | Yes | Yes | 1225 |
| Guangdong Investment | 2021 | No | Yes | No | 919 |
| Sunny Friend | 2019 | No | No | No | 747 |
| Canadian National Rail | 2020 | Yes | Yes | Yes | 462 |
| Shin-Etsu | 1995 | Yes | Yes | No | 360 |
| Essential Utilities | 2015 | Yes | Yes | No | 312 |
| National Grid | 2006 | Yes | Yes | Yes | 311 |
| ODFL | 2021 | Yes | No | No | 301 |
| TSMC | 2001 | Yes | Yes | No | 198 |
| TotalEnergies | 2001 | Yes | Yes | Yes | 197 |
| Hansol Chemical | 2021 | No | No | No | 187 |
| SM Investments | 2019 | Yes | Yes | No | 183 |
| Brembo | 2018 | Yes | No | Yes | 179 |
| Nissan Chemical | 2022 | Yes | Yes | No | 178 |
| Hang Lung Properties | 2013 | Yes | Yes | Yes | 173 |
| United Urban | 2008 | No | Yes | No | 161 |
| CapitaLand India Trust | 2019 | No | Yes | Yes | 157 |
| AirTAC | 2021 | Yes | No | No | 145 |

Source of Carbon Intensity data: MSCI. Based on all Walter Scott holdings as at 31 December 2022, emissions data run on 24 March 2023.

**CHART 1 – WALTER SCOTT – COMPANIES**




* Tonnes of Scope 1 and 2 $CO_2$ Equivalent Emissions per $m Revenue from last fiscal year available. Companies with emissions higher than 500t/$m are shown at the 500 mark and are highlighted.
** Approximate dollar invested proportionate weights of companies across all discretionary portfolios within Walter Scott.
NB. Holdings as at 31 December 2022. Emissions data run on 24 March 2023, sourced from MSCI.

Looking across our portfolios, there is limited exposure to more carbon-intensive industries, such as utilities and fossil fuels, where the transition risks outlined previously are more pronounced (see chart 1).

> *“The most significant transition risks clearly fall on the most carbon intensive companies in the economy.”*

Our portfolios typically have greater exposure to industries, such as healthcare and information technology, where transition risks, while still applicable, are likely to be less pronounced. A number of our holdings are also in a position to support the transition through the provision of their core products and services.

We expect all our investee companies to disclose emissions data to the CDP and report according to TCFD recommendations, in order to provide financially relevant climate information and data, although we recognise that in many markets there is still considerable work to be done to meet this standard.

**Climate change and long-term performance**

It is important to emphasise that our objective with the above monitoring and engagement work is about creating value for our clients over the long term.

Unaddressed climate change is a systemic risk to long-term performance for all companies, hence our analysis of all holdings. We want to ensure that our holdings could successfully operate and grow within a Paris-aligned global economy. We also focus on understanding whether holdings are exposed to additional transition or physical climate risks, and factor that into our analysis.

There can be a perception within ethical investment and beyond that it is somehow misguided or unethical to hold higher carbon-intensity companies. To challenge this view, we would reiterate that many of these companies provide the energy and infrastructure foundations of our current global economic system. They typically provide products and services that are highly valued by society, such as reliable electricity or consumer staples, and are therefore difficult to phase out entirely. These companies are also often key suppliers to the lower carbon-intensity healthcare and information technology companies that tend to dominate sustainable investment funds. Carbon intensity alone is just one factor relevant to policy makers seeking to determine the 'net social utility' of different sectors. Much more important for us as long-term investors is the overall 'direction of travel' – have management set appropriate decarbonisation targets, and would allocating capital to this transition benefit shareholders? We will be publishing our first comprehensive TCFD-aligned firmwide report in the summer of 2023, which will provide further information and analysis on the important topics above.

# OUR OPERATIONAL ENVIRONMENTAL IMPACT

**KAYU LI-AYTO**
**Head of Finance and Chair, Climate Change Working Group**

*"Meeting clients and companies is an important part of our business, but we have worked to ensure travel is conducted more efficiently."*

The return to more prepandemic working practices meant that Walter Scott, like other businesses, faced a challenge in ensuring we continued our progress towards managing our environmental impact. Overall, the company's carbon emissions for 2022 (using the location-based method and excluding emissions associated with investee companies) were 63% greater than in 2021, but 44% less than our 2019 base year (when comparing like-for-like emissions sources). Gas consumption was approximately 4% lower than 2021. However, due to the return of staff to the office, electricity consumption increased by 7%.

To support our business continuity and climate efforts almost all office desktop computers were replaced with more energy efficient laptops, whilst the annual staff survey helped us gain greater insight into scope 3 employee-related emissions associated with commuting and working from home.

During 2022, we continued working towards ISO 14001 certification, the international standard for environmental management systems (EMS), as part of parent company BNY Mellon's certification process. This will help us to assess our ability to operate an EMS and to mitigate the environmental impact of our Edinburgh offices, as well as ensuring we comply with all necessary laws and regulations.

Excluding emissions associated with our investee companies, business travel is the single largest contributor to Walter Scott's climate impact. Last year saw an increase in business travel as we held more in-person meetings with clients, prospective clients and companies around the world. Meeting clients and companies is an important part of our business, but we have worked to ensure travel is conducted more efficiently. Working with our travel provider, a new travel policy was implemented with tighter rules around air travel. Better planning has helped to ensure that, where possible, client meetings in North America are undertaken by locally based resource and supported by Edinburgh-based resource via virtual conferencing facilities, when required.

Our recycling rate, which was an average of 74% for 2022, compared to 80% in 2021 and 72% in 2019, remained above the Scottish government's 2025 target of 70%. A waste audit was performed in late 2022, the findings of which will help us identify strategies to further reduce waste. In 2022, print volumes decreased by 87% compared to the base year 2019. There was, however, a 91% increase compared to 2021 when most staff worked from home on a permanent basis.

We have moved to "digital by default" in our client communications. Unless clients specifically request a physical copy, presentations and other publications are no longer printed and bound. This practice also reduces the need to transport documents overseas.

We are committed to undertaking a review of different climate scenarios in assessing climate risk to our operations and will continue to use in limited volumes what we believe to be quality carbon offsets, given their wider socioeconomic benefits. However, our primary focus is on emission reduction efforts. We have not subscribed to any Net Zero frameworks.

# PEOPLE AND CULTURE

**RICHARD BARRY**
**Head of Executive Initiatives and Chair, DEI Working Group**

After nearly two years of working from home, February saw our team return to the office under a new hybrid working model. To date the firm has adapted well to this 'new normal', with full-time employees working from the office for a minimum of three days per week. New working arrangements mean no change to our focus, however; we remain committed to maintaining Walter Scott's unique culture and ensuring we deliver the highest standard of service for our clients.

Over 2022, we continued to develop staff wherever possible, with a focus on the following key areas: career development, leadership skills, organisation and personal effectiveness, mentoring, wellbeing, and resilience.

## DIVERSITY, EQUITY & INCLUSION

In 2022, our recently formed Diversity, Equity & Inclusion (DEI) Working Group built on our existing work on DEI. In recruitment, the use of blind CVs was extended, while we also partnered with DEI-focused groups Black Professionals Scotland, DFN Project Search and Salvesen Mind Room. Other initiatives included a diversity survey, to which 88% of employees responded, and the addition of an inclusive leadership module to our new leadership development programme.

Despite these efforts, we recognise there is more we can do with respect to DEI and the Group has worked hard to improve our understanding of some of the challenges in this area. In November, for example, the CEO of Sikh Sanjog, an organisation that provides support for women in Scotland's Sikh community, gave a talk in our offices on exclusion and isolation.

## CULTURE SURVEY

Following the success of our inaugural Culture survey in 2021, we issued our second survey in June 2022. As with the prior year, engagement levels were high, with an 85% response rate. The results were also overwhelmingly positive. Encouragingly, there was notable progress regarding career development, an area identified for improvement in the 2021 survey. The development of our hybrid working policy was also partly in response to preferences expressed in the 2021 survey for an element of home working to be retained.

The survey results were communicated to all staff, in person and online, at a series of meetings.

## FUTURE INITIATIVES

Our 2023 People Plan will be agreed by the Executive Management Committee in the first quarter of the year. As ever, its primary aim will be to strengthen further Walter Scott's existing culture. A focus group has been convened to help identify future initiatives and priorities, drawing on the wealth of feedback from 2022's Culture survey. Longer-term initiatives that began in 2022 will continue into 2023, notably Induction and Talent Assessment.

**SURVEY HIGHLIGHTS**

**98%**
—
of Walter Scott staff agree that the interests of our clients are at the centre of everything we do

**95%**
—
of Walter Scott staff are clear about what the firm is trying to achieve

**93%**
—
of Walter Scott staff believe that the firm cares about their wellbeing

## OUR PARTNERSHIPS

- **2002** British Council
- **2012** Prince's Trust
- **2015** The Robertson Trust
- **2016** Girls Who Invest
- **2017** Future Asset
- **2018** Crankstart
- **2019** Women Returners
- **2020** Investment 2020
- **2021** Juniper Trust
- **2021** Girls Are Investors
- **2022** Black Professionals Scotland

## SUPPORTING DEVELOPMENT (2022 COURSES)

| | |
|---|---|
| Hybrid Team Leadership | 7 |
| Team Development | 4 Teams |
| Leadership Development | 6 |
| Effective Feedback | 7 |
| Resolving Conflict | 9 |
| Mentoring | 11 |
| Personal Productivity & Prioritisation | 26 |
| Presentation Skills | 4 |
| Project Management | 10 |
| Career Development | 15 |
| Building Colleague Connections | 18 |
| Resilience | 26 |
| Industry Awareness | 19 |

Unless otherwise stated, numbers refer to number of employees.

# GIVING GROUP

**DENNIS WYLES**
**Client Investment Manager and co-Chair, Giving Group**

*“In 2022, the Giving Group supported 61 charities across Scotland and in Boston.”*

This was another very difficult year for charities. Multiple challenges, among them inflationary pressures, rising energy costs and continued pandemic-related disruption, combined to impact both the provision of charitable services and fund raising. Those same challenges meant that the services provided by the charities we support were more vital than ever.

In 2022, the Giving Group supported 61 charities across Scotland and in Boston, with a focus on young people, education, mental health, employment, homelessness and the community. Several new projects were supported over the course of the year, ranging from improving participation in art and musical activities to helping young people re-engage with education.

## ENGAGEMENT AND ASSESSMENT

The Giving Group's commitment to forming long-term partnerships with charities was reflected in the fact that just under 50% of the 2022 budget was allocated to multi-year programmes. Many charities are heavily reliant on annual funding, so long-term support like this not only offers valuable financial security but also enables charities to plan with confidence.

One of the pillars of the Giving Group's approach has long been a focus on specific projects where the project outline, budget, expected outcomes and evaluation are clear. This provides the Group with clear accountability for the efficiency and impact of the donations and the evaluation component is a key aspect of our assessment. This offers not only the ability to assess whether the outcomes have been delivered, but also the opportunity for further improvement to the programme in the future. We consider this to be an important part of our engagement with the charities and an area where we hope to provide value as a constructive sounding board and supporter.

We maintained a close relationship with our supported charities through the year. At each monthly meeting of the Giving Group, an invited charity provides an update on its work and the impact of our donation. These meetings also serve as a forum to discuss the charity's strategic outlook and challenges.

## EDINBURGH WOMEN'S AID

Employment for women who have experienced domestic abuse is often key to their empowerment, allowing them to build financial independence and self-esteem. However, these women often face different kinds of barriers to those of other job seekers, such as homelessness, involvement in courts, and diminished self-regard.

Through Edinburgh Women's Aid, the Giving Group supports Works4Women (W4W), which aims to help women who have suffered domestic abuse to overcome these barriers and support them on their path to employment. This can include practical support around CVs, job applications, voluntary work, and career choices, as well as softer skills, such as confidence building and health & wellbeing.

Feedback from W4W participants has been overwhelmingly positive, with a significant majority praising the programme for helping them to feel more confident and motivated, better able to communicate, and less anxious and isolated.

## VOLUNTEERING MATTERS

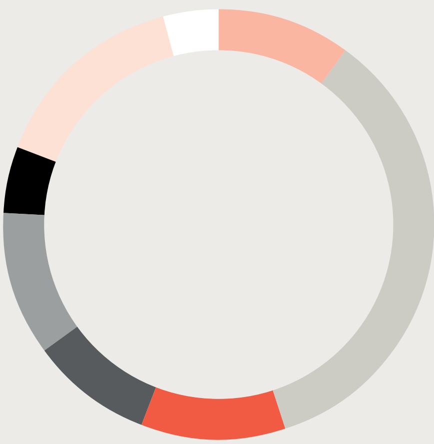
The benefits of volunteering are well known, among them making new friends, learning new skills, increased confidence, and improved mental and physical wellbeing. In 2022, the Giving Group supported a pilot

**PURPOSE AND AMBITION**

Through the Walter Scott Giving Group, the Board of Walter Scott hopes to share some of the firm's success with those in need across the local community. The purpose of the Walter Scott Giving Group is to agree on funding and ensure that such giving is impactful as well as efficient and transparent. The Group's ambition is to support local charities that focus on community, education and health. Through multi-year commitments to a number of charities, it is hoped a meaningful difference can be made. The Group has eight members from across the firm's operations and of deliberately varied levels of seniority.

> *"We maintained a close relationship with our supported charities through the year."*

**2022 BUDGET SPEND BY AREA OF NEED AND FOCUS (%)**



Homelessness 10%
Young People 35%
Employment 11%
Mental Health 9%
Education 11%
Wellbeing 5%
Community 15%
Environment 4%

project run by Volunteering Matters in Castlebrae High School, located in a high deprivation area of Edinburgh. The project provides volunteering opportunities to pupils aged 12-14 who have become disengaged from mainstream education and identified by the school as likely to benefit from a placement with a local charity. Very often these young people face significant challenges in their lives, including low self-esteem, caring responsibilities, disability, and poverty.

## OI MUSICA

Operating in deprived Edinburgh communities, Oi Musica offers young people the opportunity to learn a brass instrument and take part in street performances in the community. Not only does the initiative help develop music skills in an inclusive and informal environment, but importantly it allows young people to build confidence, socially interact and experience the enjoyment of being part of a band.

Oi Musica also offers dedicated school programmes that take whole classes on an exciting musical journey, introducing them to the basics of brass playing and drumming, and allowing them to explore their creativity. It is carefully designed to be inclusive, fun and hands-on, combining expert instruction in instrumental technique with song & movement, as well as a broader overview of world music cultures. Pupils with contrasting levels of musical experience learn together to share the success of creating a band from scratch.

## MORE THAN WORDS

The Giving Group deepened its community support in the Boston, MA area by engaging with a second charity. More Than Words provides young people (16-24 years) who are involved in the care and justice systems with paid employment in their online business. Helping young people develop new skills and overcome complex barriers, the programme is an important stepping-stone on the path to greater financial and personal independence. On graduating, each young person receives a laptop to help them continue their progress. The Giving Group's donation is covering the full cost of the 35 laptops for their 2023 Boston and Waltham graduates. As one recent graduate stated, "More Than Words gives me honest and true feedback. I've had opportunities to take a job seriously and take myself seriously. When I got suspended from school, they gave me a push to get my education, a hard push but for my own good. Now, I'm finding hope in building the life that I wish to have."

### THE YARD

From its flagship centre in Edinburgh, The Yard offers creative and inclusive play experiences in a well-supported environment for young people with disabilities and complex needs. A varied programme includes drop-in, respite and transition youth clubs, early years, specialist sessions with schools, family play sessions, and inclusive play and disability training. The Covid-19 pandemic hit these young people particularly hard through increased isolation and anxiety, so it is especially pleasing to see these activities fully open and again offering face-to-face interaction.

### FUTURE PLANS

The Giving Group's focus for 2023 will be to further strengthen relationships with our existing charitable partners, while engaging with potential new charities to support. In what is likely to prove another challenging year for charities, the provision of consistent funding and long-term support will be vital. We will remain committed to raising awareness internally of the important work being funded by the Giving Group, and to widening volunteering opportunities for individuals and teams across the firm.

# APPENDIX A

## UK Stewardship Code – Supplementary Information

### OVERSIGHT GROUPS AND STEWARDSHIP RESOURCES

**ESG Project Steering Group and working groups**
The ESG Project Steering Group ensures adequate governance, oversight and challenge of the firm's ESG project activities and compliance with the firm's related policies. The Group has responsibility for overseeing the implementation of key ESG regulations and initiatives.

This Group, its direct report, the ESG Project Group and the associated working groups successfully addressed multiple regulatory initiatives over the year. The ESG Project Group has oversight of those working groups, ensuring work is prioritised and resourced sufficiently.

Combining resource from Research Operations, Finance, Compliance, IT and Communications with resource from our Research team has proved very effective. Similarly, with regards to oversight, bringing together senior members of staff, including senior Research team members, has, we believe, been a critical factor in our success. We are confident that our project structure is well positioned to support our collective efforts to meet ongoing regulatory changes and greater client needs across this important, broad and fast-evolving field.

**Investment Stewardship Committee**
The Investment Stewardship Committee (ISC) oversees the implementation of the firm's stewardship activities and compliance with the firm's related policies. The Committee is responsible for:
(a) assessing and ensuring the quality and consistency of the firm's corporate and regulatory engagement
(b) monitoring voting decisions and records to ensure consistency with the firm's voting policy and guidelines
(c) reviewing decisions taken in relation to significant votes
(d) validation of responses to industry codes
(e) taking decisions in relation to any stewardship matters that have been escalated for its consideration
(f) reviewing and addressing any conflicts of interest relating to stewardship
(g) reviewing related policies and procedures as and when required.

The Committee has representation from Investment Research, Research Operations, Client Service and Compliance.

The establishment of the ISC in 2021 was amongst the most significant enhancements to our investment oversight in recent years. The Committee meets quarterly with ad hoc meetings when required.

**Investment Team**
The core Investment team comprises the Investment Executive and the Research team. The Research team consists of investment managers and investment analysts who work collectively across all portfolios managed by the firm.

Each stock held is championed by a member of the Research team. Typically, the champion will be the person that first proposed the idea and who is then responsible for monitoring thereafter.

The Research team is structured into three regional groups, with a combined group specifically tasked with looking at emerging market opportunities across regions, and as befits a global equity investment manager, individuals rotate amongst those teams. However, stocks are not reallocated as individuals move between regions. Those with long careers at the firm will have spent time in all the teams and will thereby champion stocks across all regions, as well as across industries. Our investment approach is centred on finding global leading companies irrespective of geographical boundaries and industry classifications. It is important that our Research team have that same perspective. In the search for the best, they must be able to contrast and compare companies across the world.

The stock champion is responsible not only for analysis and research but also engagement and proxy voting. Furthermore, they are responsible for assessing, analysing and monitoring material ESG risks and opportunities that make up an investment case. The firm does not have a separate ESG team, believing that an integrated approach is more powerful and effective. The Research team is supported by Research Operations in a number of areas of ESG integration and stewardship.

**Remuneration at Walter Scott**
Remuneration is an important part of the retention and motivation of staff and Walter Scott's approach to remuneration very much reflects its culture and its investment approach. Teamwork, contribution to team discussions and working with others to ensure the best client service, are all central to performance reviews. Beyond competitive base salaries, everyone in the firm shares an additional pool that is a percentage of the firm's annual profits. For the Research team, an individual's share of that pool is determined by a range of factors, and not solely, or indeed predominately, investment performance. Instead, that division will reflect an individual's own research and analysis, contribution to team discussions, responsibility for ESG research and stewardship with integration of sustainability risks, pursuit of innovative research, sharing of expertise and experience with other team members, as well as an evident commitment to ensuring that all aspects of the investment process meet the highest standards. In short, the proportion allocated to an individual will reflect the efforts that will underpin the long-term success of the firm, not individual pursuits or any short-term target.

The relative weights of base salary and profit share move according to performance. The components of compensation will also vary from year-to-year depending on the level of operating profit. There is, however, no cap on profit share as a percentage of base salary. For directors and some senior staff, the majority of annual compensation comprises a share of the firm's profits. An element of this is deferred via a long-term incentive plan. This is primarily invested in a global equity fund of which Walter Scott is the investment adviser with the balance in BNY Mellon stock. Both have a deferral period which vests on a pro rata basis over three or four years. Walter Scott's compensation structure is designed to promote fair and equal treatment of all staff. The Board's Remuneration and Nominations Committee reviews and approves the annual salary and profit-share allocations based on the overall performance of the firm.

## ADDRESSING CONFLICTS OF INTEREST

Our approach to conflicts of interest remains unchanged and well understood. Conflicts of interest are inherent throughout the investment management business, therefore from the outset we have organised activities to ensure the interests of our clients are always placed first and avoids material conflicts of interest that cannot be managed in the best interests of clients. Our Conflicts of Interest Policy, available on our website, sets out our approach where conflicts are unavoidable.

As an equities-only manager with all members of the Investment team working collectively to manage all portfolios, the potential conflicts that might face more diversified investment firms or where strategies are managed separately by different individuals do not apply to Walter Scott. With regards to potential conflicts emanating from ownership or outside interests, the firm is 100% owned by BNY Mellon and there are strict compliance and review processes around any individual within Walter Scott taking on any external role, whether it is remunerated or not. With regard to personal trading, again Walter Scott's rules are robust, with investment discretion in single stocks prohibited. Where individual company shares have been bought prior to employment at Walter Scott any trading must be undertaken via a prescribed list of authorised brokers who in turn are required to report any trading activity to Walter Scott's compliance department. By assuming this strict position on personal trading, potential conflicts in this regard are significantly minimised.

**Proxy Voting**
For us, potential conflicts mainly occur with regard to proxy voting. For every proxy, we check whether the company is also a client. Where there are shareholder proposals, we also check whether the proponents are clients of the firm. During 2022, there were three potential conflict situations where voting was undertaken with regard to a company that is also a client. After consideration the Investment Stewardship Committee agreed that the proposed voting was in line with the Proxy Voting Policy.

**Material Non-Public Information (MNPI)**
In the course of shareholder engagement, Walter Scott may receive Material Non-Public Information (MNPI), although our approach and process is such that receipt of such information should be infrequent.

Our process, which is communicated to all investee companies and their representatives, requires companies to send any material which is not in the public domain, and may therefore be MNPI, to Walter Scott's Risk & Compliance's electronic mailbox. This mailbox is only accessible by Risk & Compliance. On receipt of any such material, the Chief Compliance Officer, or alternate within Risk & Compliance, will review the information. If it is considered possible that the material contains MNPI, it will be passed to a "Ring Fenced Team (RFT)" for further analysis. The RFT will be considered insiders while the information is being analysed. The RFT's analysis will determine whether the information is considered MNPI.

In the case of materials which are not considered to be MNPI, the material is passed to the relevant stock champion within the Research team and the RFT ceases to be considered as insiders.

If the information is considered MNPI, the RFT will continue to be an insider until Risk & Compliance determine that the information has become public or immaterial. Until such time the material will remain confidential and ring-fenced within the RFT. At that stage, Walter Scott as a firm will not be considered an insider, and will continue to trade as normal in all stocks. While considered insiders, members of the RFT will not attend any research-related meetings and will not discuss the investment of the relevant stock with any other Walter Scott employee, whether formal or informal. That will include the stock champions if they were in receipt of the information. In addition, members of the RFT who attend the weekly Investment Management Group meeting or the more formal quarterly meeting of the Investment Management Committee should excuse themselves from the meeting if a stock is to be discussed for which they are in possession of MNPI.

## SUPPORT OF WELL-FUNCTIONING MARKETS

**Recognising our Role**

We recognise that all investment firms must play a part in encouraging well-functioning markets and financial systems. Despite our size we do believe it is incumbent upon all to proactively collaborate to address challenges and improve standards where possible.

Through our membership of the Investment Association, we continue to participate in a number of industry initiatives and working groups in relation to responsible investing, sustainability and TCFD. We have also collaborated with our parent, BNY Mellon to respond to consultations over the course of 2022.

## ONGOING REVIEW & ASSURANCE

**Overview**

The terms of reference for all board committees include the need to regularly review applicable policies to ensure not only effectiveness but that they remain in line with best practice. Our ESG Integration, Engagement and Proxy Voting policies are reviewed annually, and were last updated in March 2023.

**Sustainability Risks Policy**

The EU Sustainable Finance Disclosure Regulation (SFDR) came into effect in March 2021 imposing transparency and disclosure requirements on EU financial market participants in respect of the integration of sustainability risks. As a UK regulated firm, Walter Scott is not directly subject to SFDR as a matter of UK law. However, in anticipation of the introduction of similar rules in the UK at some point in the future, we are supportive of many of the principles of SFDR and, accordingly, we have opted to implement high-level SFDR requirements on a voluntary basis.

In March 2021, we implemented a Sustainability Risks Policy setting out our process in respect of the integration of sustainability risks in our investment decision-making process, as required by the SFDR. Under SFDR, "sustainability risk" means an environmental, social or governance event or condition that, if it occurs, could cause an actual, or a potential, material negative impact on the value of an investment. The Policy therefore approaches sustainability risk from the perspective of the risk that ESG events might cause a material negative impact on the value of our clients' investments.

**Review and Audit**

We continue to believe that our own process for review and challenge, and our parent BNY Mellon's internal audit mechanisms are sufficient at this point. With regard to our broader assurance and audit, in the second quarter of 2022, BNY Mellon Internal Audit reviewed our processes in relation to stewardship activities, including our 2021 response to the Code, as part of its periodic Investment Management Audit. This Annual Sustainability Report, incorporating our response to the UK Stewardship Code, has been reviewed and signed off by Walter Scott's Managing Director and the Investment Stewardship Committee.

**Feedback from Clients**

Client feedback is primarily gathered through conversations with clients in regular meetings over time. Whilst we believe that is the most effective way of anticipating and reacting to client needs particularly given the tenure of many clients, we do also on occasion ask for formal feedback. Over several years, we have used a major US research house to survey clients and consultants to gather impressions across all aspects of client communications. After client events we typically ask clients for feedback so that we can incorporate those views as we plan for future events.

Considerable resources were committed in 2022 to responding to client requests with respect to the establishment of our Additional Objectives Portfolios framework, enabling the conversion of Client Mandates to meet SFDR Article 8 requirements.

**Custom Client Requirements**
A number of our segregated clients have specific investment restrictions laid out in their formal investment management agreement with us. Those restrictions often relate to religious or ethical views on alcohol or tobacco, with environmentally linked restrictions also increasingly demanded. Any restriction of that nature is coded into our trade management and processing system, Charles River (CRIMS), and manual oversight checks are also undertaken. Breaches of investment guidelines are infrequent, with robust policies and procedures in place.

All portfolios are subject to a daily automated compliance check within CRIMS against measurable client guidelines to detect potential alerts or warnings. This report is reviewed daily by the Portfolio & Cash Management team and the status electronically recorded. Thereafter, exceptions are annotated with any action required or explaining why there has been a status change. This process allows the team to review all accounts daily and take any required remedial action at the earliest opportunity. Technical or passive breaches of investment guidelines can occur because of market movements or unexpected cash flows. In such instances, remedial action is taken to ensure portfolios are brought back within guidelines as soon as practicable.

More broadly, prompted by work around the management of SFDR Article 8 mandates, we have reviewed all existing client ESG / sustainable restrictions to enhance our oversight. We also introduced a new governance process and methodology for assessing the suitability of holdings for SFDR Article 8 mandates – more details are available in the Additional Objectives Portfolios section of this report.

We consider these as a collection of restrictions and challenge ourselves to ensure process and oversight is as robust and appropriate given the expectation that these requirements and restrictions will continue to increase in scope and number.

**Client Communication**
We consider effective client communication critical to what we do. Whilst, like everyone else, we have had to move to video conferencing in recent years, we do still very much value face-to-face conversations. With a relatively small number of clients and an institutional-only client base, our client service and client management teams are structured and resourced to allow regular conversations with our clients, sharing information and views whilst also soliciting feedback.

Within those conversations, interest in our stewardship activities continues to increase and we certainly now often devote more time to these subjects. Reporting on our stewardship activities has also been enhanced through the publication of our response to the UK Stewardship Code and SRD II disclosures, providing more detail around proxy voting records and significant votes.

A quarterly Stewardship commentary continues to be shared with clients and is also posted on our website. In 2022, we extended our reporting on engagement to quarterly management reports that are prepared for each client.

In addition to timetabled communications, we continue to share our research and thoughts across the spectrum of sustainable issues in several additional ways. Our Research Journal combines contributions and interviews with our Research team with those of external experts. Client events mirror our Research Journal, combining contributions from our Research team and external academics or industry experts, alongside contributions from companies around the world. Reflecting our integrated approach to ESG, and the importance of issues of sustainability and stewardship in the context of our long-term approach, sessions on environmental and social issues are very often part of the agenda.

**Shareholder Rights Directive II**
The Shareholder Rights Directive II (SRD II) aims to promote shareholder engagement and improve transparency and stewardship practices across the European Union (EU). SRD II requires asset owners and asset managers to make disclosures about their long-term investment strategies, their arrangements with each other and their engagement with the companies in which they invest. Walter Scott fully supports the goals of SRD II.

Under SRD II, asset managers must publicly disclose their Engagement Policy and, on an annual basis, outline how that policy has been implemented over the period. Walter Scott's Engagement Policy can be found on our website and the engagement case studies and company meeting information provided throughout this report show how Walter Scott implemented its Engagement Policy over the course of 2022.

Proxy voting is an integral part of our approach to Stewardship, and it is also an important part of SRD II. Our approach to proxy voting is summarised in our SRD II Report which is available on our website. That report also outlines our approach in determining significant votes as required by SRD II. Information is available on our website with updated information added quarterly.

## MONITORING SERVICE PROVIDERS

**Vendor Review & Monitoring**
Whilst we believe we have robust procedures in place to monitor the data and service providers used within our investment process, it is important to stress that we do not rely on external inputs and they will only ever be part of a process of gathering information. Therefore, while we have robust and extensive processes around vendor take-on as well as ongoing service monitoring, actionable criteria are not required as formal and full reliance is not placed on any single source of information. It is central to Walter Scott's consistently applied investment approach that the Research team and Investment Executive comes to their own conclusions and investment views.

Because investment decisions do not rest upon a single data point or input from an external research or service provider, there is no need to use any particular source or provider of external research. However, there is of course value in gathering data to help build a long-term investment case for a particular company, and the Research team is given the resources it needs to undertake that work, be that through very general and broad services, such as Bloomberg, or very specific inputs on environmental data, for example. Utilising the systems and processes of our parent company, BNY Mellon, we have extensive and robust vendor management procedures. Those procedures and checks do not only cover the take on or cessation of a vendor but they also require ongoing monitoring. Those ongoing processes include a formal, documented annual review. Whilst dialogue must be ongoing, that annual review is structured to include consideration of any previous issues as well as possible improvements. Where the relationship or service being provided is material to the business, a meeting, rather than just an exchange of correspondence, with documented notes, is required within the review. In 2022, after considerable due diligence, we extended our contracted services with MSCI to provide additional ESG information, such as Principal Adverse Impact Indicators.

**Proxy Voting Materials**
We currently receive proxy voting materials from ISS and use its platform to submit all votes. We also gather materials directly from the company. Engagement with the investee company, as well as a 'common-sense' check by the stock champion also helps to highlight any errors in the materials being provided. We do not provide ISS with our Proxy Voting Policy nor do we ask them to follow it. We reach our own decision on how to vote: we do not rely on ISS to determine that decision and we instruct them on our final decision. ISS process votes for us and in doing so we ask them to confirm to us that those votes have been processed and submitted. We rely on ISS' own checks to ensure that processes and submitted votes are then counted.

**Ongoing Review**
We continue to consider additional data providers but whilst the number of approaches we have from providers, particularly across environmental and social metrics, continues to increase, none of those that we have investigated would add materially or specifically to our existing sources. With so many new providers, as well as new technologies, we will keep this under regular review.

# APPENDIX B

## Streamline energy and carbon reporting ("SECR")

The Walter Scott SECR table is disclosed below. Whilst the table represents the firm's best efforts in capturing the data, it is worth highlighting that methodologies may change or there may be different ways of capturing and presenting the data in the future. The annual reporting period, 1st of January to the 31st of December, is aligned with the financial year. The conversion factors applied, specific to the year reported for 2019 to 2022, have been published by the UK Government: Department for Business, Energy & Industrial Strategy.

In accordance with the Companies Regulations 2018, the Company reports its energy use and associated greenhouse ("GHG") emissions resulting from energy use in its UK buildings and employees' business travel. Due to the nature of the business' primary business activity and location of clients, business travel emissions reported include international travel and is not restricted to travel that both starts and ends in the UK.

The Company has voluntarily reported additional emission types, where applicable utilising the calculation methodologies set out per the Greenhouse Gas Protocol, A Corporate Accounting and Reporting Standard Revised Edition, defined by the World Resources Institute/World Business Council for Sustainable Development ("WRI/WBCSD").

Per the GHG Protocol Scope 2 Guidance, Scope 2 emissions using both the locationbased and marketbased methods have been reported. The marketbased method reflects emissions from electricity arising from a renewable energy supply contractual arrangement whereas the locationbased method does not.

### METHODOLOGY NOTES

1. Walter Scott's Scope 1 emissions includes emissions from the tracked use of natural gas in occupied facilities. Natural gas usage is tracked using meter readings at each of the buildings occupied in Edinburgh, UK.

2. Location-based Scope 2 grid electricity emissions are estimated based on recorded consumption in kWh which are then converted using UK government emissions conversion factors for each applicable year.

3. Grid electricity usage is recorded through meter readings in each of the buildings occupied in Edinburgh. Our energy provider supplies 100% renewable electricity from solar, wind and hydro. The supplier buys electricity on the wholesale market and for every unit purchased a Renewable Energy Guarantees of Origin (REGO) certificate is bought to match. From 2020 to 2022, electricity has been supplied in this manner, meaning that the firm can report a reduced emission figure under the market-based method.

4. Purchased goods and services includes all upstream emissions from production of products and services acquired. This includes both tangible and intangible items and has been calculated using the hybrid method according to the GHG Protocol. This involves the use of a combination of supplier provided emissions data and the use of secondary data. Emissions reported are calculated using the most current Scope 1 and 2 emissions data specific to the vendor and where data is not available no estimate has been made. Figures are not provided for 2019 and 2020 due to a lack of available data.

5. Waste generated in operations has been reported as the total mass of waste recorded by the waste management companies that service our offices. Reported emissions relate to those emitted in the end-of-life disposal process, in accordance with the GHG Protocol waste-type-specific-method and have been calculated using the weight of waste materials multiplied by the relevant annual UK government emissions conversion factors.

6. Scope 3 business travel emissions include international travel due to the nature of the business' primary business activity and location of clients. Our travel provider calculates the average estimated carbon emissions associated with each business trip and as such the calculated emissions will vary depending on factors including

## WALTER SCOTT EMISSIONS DATA

| | Unites (kWh) | | | |
|---|---|---|---|---|
| **Energy Usage** | **2022** | **2021** | **2020** | **2019 (baseline)** |
| Gas combustion | 331,610 | 344,627 | 348,278 | 381,758 |
| Grid electricity consumed (location-based) | 257,283 | 241,353 | 238,357 | 296,111 |

| | GHG Emissions (metric tonnes $CO_2e$) | | | | |
|---|---|---|---|---|---|
| **Emission Source** | **2022** | **2021** | **2020** | **2019 (baseline)** | **Note** |
| Scope 1: GHG Emissions | 68 | 70 | 71 | 78 | 1 |
| Scope 2: GHG Emissions (location-based) | 50 | 51 | 56 | 74 | 2 |
| Scope 2: GHG Emissions (market-based) | 0 | 0 | 0 | 26 | 3 |
| Scope 3: GHG Emissions | 660 | 2,368,995 | 2,704,640 | 2,804,590 | |
| 1. Purchased Goods and Services[1] | 124 | 160 | n/a | n/a | 4 |
| 5. Waste generated in operations | 0.4 | 0.3 | 0.2 | 0.5 | 5 |
| 6. Business Travel | 359 | 44 | 111 | 698 | 6 |
| 7. Employee Commuting[1] | 177 | 205 | n/a | n/a | 7 |
| 15. Investments[2] | n/a | 2,368,585 | 2,704,528 | 2,803,891 | 8 |
| **Total Gross GHG Emissions** | **778** | **2,369,116** | **2,704,767** | **2,804,742** | |

| | GHG Emissions (metric tonnes $CO_2e$) | | | |
|---|---|---|---|---|
| **Intensity Metrics (Per Person Employed Unless Stated)** | **2022** | **2021** | **2020** | **2019 (baseline)** |
| Scope 1: GHG Emissions[3] | 0.39 | 1.84 | n/a | 0.50 |
| Scope 2: GHG Emissions (market-based)[3] | 0.00 | 0.00 | n/a | 0.17 |
| Scope 3: Purchased Goods and Services[1] | 0.71 | 0.94 | n/a | n/a |
| Scope 3: Business Travel per person travelling[4] | 5.80 | 2.32 | 3.26 | 10.91 |

[1]Emissions not provided for 2019 and 2020 due to lack of available data.
[2]Emissions associated with the investments managed by Walter Scott on behalf of clients for 2022 are not reported due to a lack of available data. Additionally, investee company emissions reported for 2019 to 2021 have been restated following additional disclosures since the prior reporting period.
[3]Persons Employed (PE) figure based on annual average of individuals working in the UK offices. Data not provided for 202 due to minimal PR working from Company's UK offices due to COVID-19 lockdowns.
[4]Persons travelling figure represents the number of individual employess travelling during the year.

the route and class of travel. Emissions associated with hotel accommodation required for business travel have been included in the 2022 figure and this was not reported in prior years due to lack of available data.

7. Employee commuting includes emissions from the transportation of employees between their homes and the workplace. Additionally, emissions from teleworking (i.e. employees working remotely) have been included within this category – which in the 2021 SECR statement had been reported within the category 'Fuel and energy related activities not included in Scope 1 or 2'.

   Transportation emissions associated with employee commuting have been calculated in accordance with the GHG Protocol distance-based-method. The calculations were supplemented with the results of a staff survey conducted in Q3 2022, which gathered information at a respondent level to improve overall accuracy. Details including, mode of transport used; distance from the office; and frequency of travel were collected.

   Emissions associated with employee home working have been reported using the results of the staff survey conducted in Q3 2022, in accordance with the GHG Protocol average data-method, as an estimate was required to determine the average energy consumption of an individual when working from home. The survey gathered information at a respondent level including the type of energy tariff the member of staff held at home; the number of electrical devices used; and whether they used additional heating or cooling equipment to enhance the accuracy of the average data-method calculation.

8. Emissions associated with the investments managed by Walter Scott on behalf of clients are reported using the investment-specific method according to the GHG Protocol. This method involves collecting Scope 1 and 2 emissions from the investee company and allocating the emissions based upon the share of investment on the 31st of December for the year reported. While the reporting guidelines for investment emissions in the GHG Protocol Corporate Value Chain (Scope 3) Accounting and Reporting Standard emissions are mostly clear, accurately capturing investment emissions is complex and for this reason emissions reported should considered as an estimate. As Scope 1 and 2 investee company data was not available for all holdings for 2022 at the time of publication, emissions have not been reported.

# APPENDIX C

## Walter Scott Sustainability, ESG Integration and Stewardship Glossary

Sustainability and ESG terms continue to evolve and are at times defined and interpreted differently across different regions and within the investment industry. The glossary below is our definition of current terminology.

***Additional Objectives Portfolios (AOPs):*** These are Walter Scott portfolios relating to clients who have opted to include additional environmental, social, and/or governance requirements in their investment guidelines or mandate.

***Additional Objectives Portfolios Process:*** This is Walter Scott's proprietary process for assessing the suitability of holdings for AOP clients, overseen by the internal AOP Group.

***Carbon Neutral:*** This is a state achieved when unabated carbon emissions are compensated for, or balanced by, another means, often through purchasing carbon offsets and/or renewable energy credits.

***Climate-related Physical Risk:*** This refers to the risk climate change poses to physical assets or operations, such as direct damage to assets and indirect impacts from supply chain disruption. Organisations' financial performance may also be affected by changes in water availability, sourcing and quality; food security; and extreme temperature changes affecting organisations' premises, operations, supply chain, transport needs and employee safety. Physical risks resulting from climate change can be event driven (acute) or longer-term shifts (chronic) in climate patterns.

***Acute Risk:*** Acute physical risks refer to those that are event driven, including increased severity of extreme weather events, such as cyclones, hurricanes, floods or wildfires.

***Chronic Risk:*** Chronic physical risks refer to longer term, ongoing shifts in climate patterns (e.g., sustained higher temperatures) that may cause sea level rise, long-lasting droughts or chronic heat waves.

***Climate-related Transition Risk:*** This refers to the risks associated with the transition to a low-carbon or Net Zero economy. The most common transition risks relate to extensive policy, legal, technology and market changes to address mitigation and adaptation requirements related to climate change. Depending on the nature, speed and focus of these changes, transition risks may pose varying levels of financial and reputational risk to organisations if they do not comply or adapt.

***Environmental, Social and Governance (ESG):*** 'ESG' is a banner term for a range of potentially relevant investment issues. We use ESG as an investment research tool to help identify key opportunities and manage risks deriving from corporate governance and sustainability factors.

***ESG Integration:*** This describes the incorporation of material environmental, social and governance factors into financial analysis and investment decisions to better manage risks and improve returns.

***EU Taxonomy:*** This is an environmentally sustainable classification system established to fulfil the EU´s climate and environmental objectives. It establishes clear criteria for defining environmentally sustainable economic activities which make a substantial contribution to at least one of the EU's objectives, whilst not significantly harming any of those objectives and meeting minimum social safeguards. By introducing mandatory disclosure obligations on some companies and investors, the EU's aim is for the taxonomy to act as a 'transparency tool' facilitating comparison of companies and investment portfolios thereby guiding market participants in investment decisions.

***Net Zero:*** This describes the state when a corporation reduces its relevant scope 1, 2 and 3 category greenhouse gas (GHG) emissions following science-based targets, below 1.5°C pathways as much as possible, with any remaining GHG emissions being fully neutralised by like-for-like removals, for example permanent removals of fossil carbon emissions.

***Proxy Voting:*** This refers to ballot casting by a person or firm on behalf of a shareholder of a corporation.

***Exclusionary/Negative Screening:*** This is a rules-based approach to remove investments from the investable universe based on a particular set of values. It could involve the exclusion of certain sectors, companies, countries or other issuers based on activities considered not investable. Exclusion criteria (based on norms and values) can refer, for example, to product categories (e.g., weapons, tobacco), company practices (e.g., animal testing, violation of human rights, corruption) or controversies.

***Impact Investing:*** This is the practice of investing with the dual objectives of generating a positive, measurable and intended social and/or environmental impact alongside generating a financial return.

***Stewardship:*** This is the practice of active ownership to create long-term value for clients and beneficiaries. Stewardship activities include, but are not limited to, engagement with issuers; voting at shareholder meetings; filing of shareholder resolutions/proposals; engagement with policymakers; engagement with standard setters; contributions to public goods (such as research); and public discourse (such as media) that support stewardship.

***Responsible / Sustainable Investing:*** This describes an approach to investing that prioritises additional social and or environmental objectives alongside investment returns. At Walter Scott, such an approach to investment is managed by our Additional Objectives Portfolios process.

***Science-Based Targets (SBTs):*** GHG reduction targets are considered science-based if they are in line with what the latest climate science deemed necessary to meet the goals of the Paris Agreement. This is limiting global warming to well below 2°C above pre-industrial levels and pursuing efforts to limit warming to 1.5°C.

***Socially Responsible / Ethical Investing (SRI):*** These are more dated terms for the exclusionary practice of not investing money in companies and funds that are deemed to have negative social or environmental impacts.

***Sustainability Disclosure Requirements:*** Proposed UK sustainable investment disclosure and 'anti-greenwash' regulations being progressed by the Financial Conduct Authority.

***Sustainable Development:*** In 1987, the United Nations Brundtland Commission defined sustainable development as the practice of "meeting the needs of the present without compromising the ability of future generations to meet their own needs."

***Sustainable Finance Disclosure Regulation (SFDR):*** Introduced by the European Commission, the SFDR imposes mandatory ESG and sustainable investment disclosure obligations for asset managers and other financial markets participants. SFDR aims to bring a level playing field for financial market participants and financial advisers and transparency in relation to sustainable investment and accompanying risks.

***SFDR Article 8:*** Walter Scott is not directly captured by SFDR as we are a UK regulated firm. However, we act as the sub-advisor to EU funds, which are captured by SFDR, and the client has requested an Article 8 fund. SFDR Article 8 products must promote, among other characteristics, environmental and/or social characteristics. Companies in which the investments are made must follow good governance practices, particularly with respect to:

- Sound management structures
- Employee relations
- Remuneration of staff
- Tax compliance.

SFDR Sustainable Investments: SFDR defines a 'sustainable investment' as an investment in an economic activity that contributes to an environmental objective, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and GHG emissions, or on its impact on biodiversity and the circular economy, or an investment in an economic activity that contributes to a social objective, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities, provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance.

This breaks down into three sections:

- Economic activity that contributes to an environmental / social objective
- Do No Significant Harm (DNSH) objective
- Good Governance Practices (the following four limbs should be taken into account when assessing good governance of investee companies):
  - Sound management structures
  - Employee relations
  - Remuneration of staff
  - Tax compliance

***'Do No Significant Harm' (DNSH):*** The 'do no significant harm' principle applies only to SFDR Sustainable Investments in that they do not have a significant impact on other environmental or social objectives. Please refer to SFDR Sustainable Investments.

***Principle Adverse Impact Indicators (PAIs):*** The 'PAI Regime' aims at improving transparency for clients, investors and the market regarding how financial market participants integrate the consideration of the adverse impacts of their investment decisions on sustainability factors into their investment processes.

***SFDR Defined Sustainability Factors:*** Environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters.

***Sustainability Indicators:*** These are used to measure the attainment of each of the environmental or social characteristics promoted by an SFDR Article 8 financial product.

***Task Force for Climate-related Financial Disclosures (TCFD):*** The Financial Stability Board established the TCFD to develop recommendations for more effective climate-related disclosures that could promote more informed investment, credit and insurance underwriting decisions. The recommended Financial Disclosures are organised into four categories: Governance, Strategy, Risk Management, and Metrics & Targets. The TCFD is unique in that it focuses on assessing the ability of a company to mitigate risks and maximise opportunities related to climate change.

***United Nations (UN) Sustainable Development Goals (SDGs):*** In 2015, the UN General Assembly adopted a new global sustainable development framework: the 2030 Agenda for Sustainable Development. At its core were the 17 SDGs covering three dimensions of sustainability: economic, social and environmental. They broadly cover strategies to end poverty, improve health and education, reduce inequality, promote economic growth and address climate change.

***United Nations Global Compact (UNGC):*** The UNGC is the world's largest corporate sustainability initiative, encouraging companies to align strategies and operations with universal principles on human rights, labour, environment and anti-corruption.



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**Glen Scouller**
Sand and seaweed, Colonsay

Walter Scott has been supporting emerging Scottish talent since 1988. In the same way that we believe that different perspectives within the team generate the best investment ideas, so we believe that our art collection should incorporate a wide range of work from an eclectic group of contemporary artists.

Our commitment to the art community is also reflected in our established partnerships with the Royal Scottish Academy, the Royal Glasgow Institute of the Fine Arts and the Royal Scottish Society of Painters in Watercolour.

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